



SECURING KENTUCKY'S FUTURE

PREPARED BY THE
ADMINISTRATION OF
GOVERNOR PAUL E. PATTON
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FOREWORD

The Commonwealth of Kentucky is facing the most severe fiscal crisis since World War II. In FY 02, for the first time since 1954, revenue actually declined from the previous year. We are well into the third year of anemic revenue growth. No other administration in recent history has faced an actual decline in revenue and no other administration has experienced three years of virtually flat revenue. Since November of 2001, the administration has managed to address almost one billion dollars in revenue shortfalls without significantly impacting our citizens. That is about to change.

Increased costs in Corrections and Medicaid in the current fiscal year, which have been caused in part by our weak economy, have forced the administration to curtail the growth of these expenses. The reaction to the release of felons and the cutbacks in Medicaid has been substantial. That is just a precursor of things to come if we must live with current revenue.

The Commonwealth is facing its darkest hour – and, at the same time, perhaps its greatest opportunity in the past decade to move Kentucky forward. We have an opportunity to make a quantum leap in our struggle to improve our quality of life and standard of living relative to our sister states – if we have the wisdom and the strength.

We are not alone in this fiscal crisis. More than half the states are facing budget shortfalls in FY 03. Nationwide, the average is 10 percent. Because of good management, Kentucky will not have to cut our budget in FY 03. But we will be 5.5 percent short next year, not counting cost overruns in Corrections and Medicaid, 5.9 percent if we count the cost overruns. Just because we have so far prevented our citizens from suffering the pain of government cutbacks already felt by the citizens of many other states does not mean we have escaped it. It just means we delayed it; giving our leaders one last opportunity to prevent it. Many states like Tennessee, Illinois, Indiana and Ohio have already enacted tax increases of the magnitude proposed by Governor Patton. Not keeping up with these neighboring states' efforts to adequately fund education and other vital services will mean that we will fall further behind them than we already are.

This report is submitted to the people of Kentucky to demonstrate the structural imbalance which has been created over time between the needs of our citizens and the tax code which generates the funding to meet those needs. The Patton Administration proposes to reform the Commonwealth's tax code to restore adequacy to General Fund revenue, make the tax code more fair, improve the stability of revenues, allow revenues to grow more closely with the growth of our economy and the needs of a growing society and keep Kentucky competitive for economic development.

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EXECUTIVE SUMMARY

In November 2002, the Administration of Governor Paul E. Patton presented *An Assessment of Kentucky's Fiscal Condition*, a report that clearly stated the problems and challenges facing the Commonwealth during our current period of anemic revenue growth. The report put forth an earnest effort to start "a bipartisan dialogue to address the options of reducing important services or increasing revenue to pay for commitments we have already made". *Securing Kentucky's Future* follows this earlier report with specific recommendations that the Patton Administration proposes to address the growing gap between revenues and the commitments made to the citizens of the Commonwealth by their government.

The options are clear; reduce spending further or enhance revenues. State Government has already absorbed almost a billion dollars in revenue shortfalls. One-time resources have been exhausted and budgets have been cut and cut again. The biennial budget presented to the Extraordinary Session of the General Assembly in April of 2002 as HB 1 contained no new commitments and fell short of a budget that would have moved Kentucky forward. With revenue falling short of the amount needed to fund that continuation budget, we have no choice except to make the tough leadership calls we can no longer avoid. Will we as a society support further cuts to existing commitments or will we enhance our revenue base so that we can fund the vital needs of our people? The additional funds for the rest of the current biennium not in HB 1 which are needed to keep Kentucky from moving backwards are presented in Table 1 on Page 17.

The boom in the state and national economies in the late 1990s allowed Kentucky to maintain adequate governmental services while simultaneously implementing 26 tax cuts which have saved Kentuckians over \$2 billion so far and will save them \$485 million in FY 04 and more in the years ahead. Since 2000, however, the economy has not followed the path of the late nineties when taxes were being reduced. Consequently, our weakened revenue base cannot fund the current needs of the people of the Commonwealth in periods of normal and below-normal economic growth such as we are currently experiencing.

This report outlines changes in our tax code which will provide additional revenue to adequately fund our current commitments. It also outlines the steps that are necessary to make our tax code more fair, less volatile and better equipped for revenue to grow in line with our economy and the growing needs of our citizens while keeping Kentucky competitive for economic development projects relative to our neighboring states.

The approach recommended by the Governor is comprehensive in nature; guided by an articulated philosophy on taxation. Our guiding principles, beginning on Page 21, outline the reasons for our proposed changes. Our proposals are consistent with changes recommended by the Kentucky Commission on Tax Policy appointed by Governor Brereton Jones in 1995, and in both of the Barents Group studies and Dr. William Fox's 2002 report to the LRC Subcommittee on Tax Policy Issues. In the short run, the proposal generates the new money needed to solve the unprecedented budget crisis we face in Fiscal Year 04. Of equal importance is the goal of restoring a firm financial footing to our revenue base so that

future administrations will inherit a tax system which will generate a revenue stream adequate to provide for the needs of the people of the Commonwealth.

The remainder of this executive summary will outline, tax-by-tax, the areas for reform. In some cases, like the Property Tax, our proposal leads to lower projected revenues. In other cases revenue is enhanced. In all cases we believe our solutions are the right thing to do. We welcome the public debate which will accompany our proposals for comprehensive reform of Kentucky's General Fund revenue-generating tax code.

Individual Income Tax

Three reforms are recommended for the Individual Income Tax. The net result is a slight revenue increase over the current structure. First, previous studies have highlighted the fact that Kentucky has a high overall tax burden for our low-income working families relative to the rest of Kentucky taxpayers. In response to this generally acknowledged fact, we recommend increasing the threshold for our low-income tax credit while simultaneously eliminating a loophole that allows wealthier taxpayers who have high levels of "exempt" income to potentially qualify for the credit. These changes will result in \$31 million of reduced revenue in FY 04.

The second modification would phase out the tax-exempt status of some or perhaps all retirement income for higher-income retirees. This is simply a matter of trying to make our tax system fairer to all taxpayers. If our struggling middle-class families must pay the full rate on their income, why should the highest income person in Kentucky get a \$2,364 tax break under the current law simply because a portion of their income is from a pension? Closing this loophole will generate \$75 million more revenue in FY 04.

Finally, we propose to eliminate the deduction from the Kentucky Individual Income Tax owed for taxes paid to a foreign country. If taxes paid to the United States of America are not deductible, then this deduction is a loophole that surely needs to be closed. This change will generate \$3.4 million more revenue in FY 04.

Sales Tax

All of the previous examinations of our tax code recommend a "broader base" for our Sales and Use Tax, concentrating mostly on taxing more services.

We recommend taxing a few more services which, by their very nature, cannot be easily exported from Kentucky. The services selected for inclusion in the Sales and Use Tax base have all been identified in earlier studies as good candidates for the Sales and Use Tax. The five services listed on Page 28 would generate about \$49 million in additional Sales and Use Tax revenue in FY 04.

We also propose imposing the Sales and Use Tax on unbundled natural gas transactions and Dot.com affiliates of Kentucky retailers. While the revenue lost to these loopholes is small now, \$11.0 million in FY 04, it could grow substantially in the years ahead.

One significant proposal which is revenue neutral to the Sales and Use Tax we are currently collecting is the Streamlined Sales and Use Tax Initiative sponsored jointly by the National Governors Association and the National Conference of State Legislatures. Kentucky is currently losing an estimated \$100 million a year in taxes owed but not paid because of sales made by remote vendors that we cannot require to collect the Sales and Use Tax for us. Kentucky and nine other states must conform to this protocol for it to go into effect. If that happens, we could begin to recoup this lost revenue in two or three years. No matter what happens to the rest of this proposal, this measure must be passed to prevent severe erosion of this revenue source in the future as internet sales accelerate.

Property Tax

The Governor's proposal advocates three changes to the Property Tax code. First, the Governor proposes that we freeze the rate on real property at \$0.135 per \$100. The rate has fallen precipitously since the enactment of HB 44 in 1979. By freezing the rate, growth in that revenue source can more accurately mirror the underlying growth of our economy. This will generate \$4.8 million in FY 04 and will materially contribute to a growth rate for the Property Tax revenue stream which more nearly reflects the growth of our economy and the needs of our people.

The second and third changes represent tax reductions to the taxpayers of Kentucky. The Governor proposes to remove the remaining Property Tax on certain classes of intangible property which will save taxpayers \$33.5 million in FY 04.

The proposal also repeals the state Property Tax on motor vehicles and boats. This proposal will reduce revenues \$83.5 million in FY 04. This tax is particularly disliked by the citizenry since it is paid in a very visible lump sum once a year and none of our neighboring states has this state tax.

Corporate Tax

Our corporate taxes have declined from 10 percent of the General Fund in 1990, the year of the KERA related tax increases to 5 percent in Fiscal Year 02. That is a dramatic reduction. Two major factors contribute to this erosion of corporate support for state government. First, our current corporate tax code contains loopholes that permit businesses to organize themselves in ways that minimize or even totally eliminate their tax liability in Kentucky. Second, since our Corporate Income Tax is based on profits, and since profits are highly sensitive to the national business cycle, the performance of this revenue stream is

quite erratic and unreliable. However, the business community's use of public services like education, infrastructure, public protection and business regulation is not cyclical. These services are a stable and growing cost of state government. They must be funded by a stable and growing revenue source.

Clearly, corporate support for state government has not kept pace with the overall growth of the General Fund and has lagged behind the growth required to adequately fund our commitments to the people and the business community. Governor Patton recommends a tax structure that generates a more stable source of state revenue at levels adequate to provide a vibrant economy with qualified, highly educated workers and other necessary state services. The 10 percent of total General Fund revenue from the business community proposed by the Governor is more in line with the historical business support for Kentucky State Government and the business support for the governments of our neighboring states.

The LLP, LLC, LP, and s-corporation are four different legal business entity structures that have evolved into vehicles for the reduction and potential elimination of business tax liability in Kentucky. Different combinations of these legal entities may result in substantially different tax liabilities for two different businesses that provide identical goods or services in the same marketplace. To be fair to all businesses, reform in this area is needed to ensure that every business, regardless of its structure, contributes in an equitable way to the financial support of the public services which make Kentucky a first rate place for businesses to operate. It is difficult to argue that an existing tax code is fair when two businesses, with identical production facilities and payrolls, can face drastically different tax liabilities, because one is avoiding the Corporate License Tax and the Corporate Income Tax because of the way it is organized. Creating these organizational structures is not hard to do.

The Governor strongly advocates a new proposal to bring fairness and stability to our tax system while simultaneously producing a revenue stream from our business citizens which helps us adequately fund existing commitments.

His proposal is to repeal the Corporate Income Tax and replace it with a Business Activity Tax (BAT) and rename the Corporate License Tax the Business License Tax (BLT), and raise the rate from \$0.21/\$100 of capital employed to \$0.41/\$100. These taxes will apply to virtually every business in Kentucky operating under the state-provided umbrella of limited liability. Exceptions include banks and insurance companies because Kentucky has unique laws to tax financial institutions. Partnerships for professionals such as doctors, lawyers, accountants, etc. will also be exempt. These changes will also have little, if any effect on pass-through companies owned by Kentucky taxpayers because the additional taxes paid by the company will also be passed through to the owners and deducted from the Individual Income Tax they owe Kentucky. Public service companies (except for communications companies) will not be subject to the BLT.

Instead of business income as the base for the BAT, as it is for the Corporate Income Tax, we propose a two-factor tax based on Kentucky payroll and sales made in Kentucky. The rates for payroll will be \$0.60/\$100 and the rate for sales will be \$0.13/\$100.

This proposal would cure the systemic weaknesses of the current system and the problem of volatility of business support for state government. By applying both of the new taxes to virtually all business entities, Kentucky firms no longer would have to use the legal loopholes for the minimization of their Kentucky tax liability in order to compete on a level playing field.

A driving reason for this change is stability of the revenue stream. While profits tend to exhibit dramatic swings, payroll and sales remain more stable. This stability will more closely mirror the steady demand that businesses have for an educated workforce and other public services. Over time, this proposal will be fair to businesses as the annual cycle of high profit, low profit and no profit averages out to a reasonable return on investment for the owners. This proposal will create a taxing system which will be more fair, stable and not subject to manipulation. As dramatic as this option may seem, it would be the *single most important action* that could be taken to return fairness to the system. This proposal will increase revenue by \$340 million in FY 04.

Tobacco Taxes

The Patton Administration has been an unquestioned advocate for the Kentucky tobacco farmer. From Governor Patton's leadership in securing a favorable allocation of dollars from the Phase II tobacco negotiations to his support for 50 percent of the Phase I payments being set aside for Kentucky's farmers, we have shown time and time again that our support is truly genuine. Even though we now advocate higher taxes on tobacco consumption as a way to find much needed revenues, citizens of the Commonwealth should in no way construe this as a waiver in our commitment to tobacco farmers. The demand for leaf tobacco is national and even international. Even if Kentucky consumption dips slightly as a result of a tax increase, the effect on the overall international demand for our Kentucky grown tobacco will be insignificant.

As this report demonstrates, our tobacco taxes are significantly lower than our neighboring states. Moreover, we have no excise tax on other tobacco products such as snuff, cigars, chewing tobacco, and loose smoking tobacco. By increasing the excise tax on cigarettes by 37 cents per pack, very close to the average of our 7 contiguous states, and levying an equivalent 13 percent excise tax on other tobacco products, we can raise \$167.4 million in FY 04.

Other Proposed Reforms

Other proposed reforms include taxing merchant power plants (\$1.4 million), increasing the provider tax on nursing facilities and immediate care facilities for the mentally retarded (\$52.9 million), and revising the way we tax the communications industry (\$16.3 million more).

This report also highlights major problems with Road Fund revenue relative to our commitments to build new roads, a problem the Governor has discussed for four years to no avail. Realizing the magnitude of the task of reforming the General Fund tax code, the Governor

is not proposing changes in the Road Fund tax code at this time. He does, however, feel obligated to continue to articulate the problem which is just a year or so short of reaching the crisis stage which has already affected the General Fund.

Conclusion

The Administration has done everything it can to weather the current storm by cutting administrative costs and using nonrecurring resources. These options are exhausted and the time has come to look for sustainable ways to bring our budget back into structural balance. The proposals set forth in this report have elements of tax decreases and tax increases to achieve that goal. At all times we strived to adhere to the stated principles of good tax policy.

The Governor's proposal is summarized in Table 8 on Page 82. We think these changes are the right thing to do so we can keep Kentucky moving forward, keep Kentucky competitive, and keep honoring our commitments to the citizens of the Commonwealth well into the next decade.

THE PROBLEM IS NATIONWIDE

Kentucky has serious budget problems; but we are not alone and certainly not in as bad shape as many other states. Many states faced the major part of their budget shortfalls in FY 02 and raised taxes or cut back on state programs then to get their budgets in structural balance. According to the National Conference of State Legislatures, more than half the states are still facing budget shortfalls in FY 03. Two-thirds of the states are failing to meet revenue projections and more than half of the states are experiencing expenditures above budgeted levels. While Kentucky has not yet raised taxes or made major programmatic cuts, we face both a revenue shortfall and increased expenditures in FY 04.

Early in FY 03, 31 states reported budget gaps in excess of \$49 billion, approximately 10 percent. California faces a 19 percent budget gap this year; Massachusetts faces 15 percent, and Virginia faces 10 percent. Kentucky's projected budget shortfall for FY 04 is 5.5 percent.

Twenty-four states have enacted tax and fee increases for FY 03 totaling \$8.3 billion, the largest net state tax increase since 1992. These tax and fee increases covered almost all areas of taxation including sales, personal and corporate income, tobacco, motor fuels, and alcohol.

Among the states which have already faced this problem are our four closest neighbors. Tennessee has raised taxes \$933 million including \$127.4 million in corporate income taxes. Tennessee was already getting 15.3 percent of its revenue from corporations compared to Kentucky's 5.2 percent. Ohio raised taxes last year \$797 million including \$216 million from corporations although it was already getting 15.3 percent of its revenue from corporations. Illinois has raised taxes \$370 million and Indiana has raised taxes over one billion dollars. In calling for more tax increases in January of this year, Governor Taft of Ohio said to his legislature, "The actions I'm asking you to take will be painful, but the consequences of inaction are unacceptable."

In addition to these actions, several other states are considering large tax increases to address budget problems. These include Nevada where Governor Guinn has proposed a \$980 million tax package, including a gross receipts tax, a new admissions and amusement tax and increases in the business license tax, cigarette and alcohol taxes and property taxes. Connecticut Governor Rowland, in addressing a \$650 million shortfall, has expressed intentions to raise income taxes on higher-income individuals, increase the sales tax on computer services, increase cigarette taxes and reduce sales tax exemptions on clothing. In Idaho, Governor Kempthorne is proposing an increase of 1.5 percent in the sales tax and an increase in the cigarette tax of 34 cents to address that state's 8.1 percent budget deficit. In describing his action, Governor Kempthorne, the incoming Republican Chair of the National Governors Association, said, "I have done something that is absolutely not part of my fiber, but I'm not going to dismantle this state, I'm not going to jeopardize our bond rating, and I'm not going to reduce my emphasis on education."

The newly elected Governor of Georgia, Sonny Purdue, justifying his call for higher taxes, said, "No Republican governor wants to propose even a modest tax increase his first week in office, but this is the budget I believe the situation demands."

Governor Mike Huckabee of Arkansas said to his legislature, "And if you deem that all new revenue sources, your proposals or mine, are dead on arrival, then you'll be saying that teacher pay increases are dead, scholarships are dead, medicine for the elderly is dead, that long (prison) sentences are dead, and that we'll have to have a massive early release of thousands of inmates from the system. To be blunt, our problems aren't that simple and the answers aren't either."

Some states, with Republican and Democratic leadership, are facing up to the crisis. Others are in denial. There is no silver bullet for these states – or Kentucky.

How we and our sister states handle this crisis will determine where we will be relative to each other economically and socially twenty years from now. Some states are taking the easy road and cutting education, social services and public protection programs; stopping progress and, in fact, going backwards. A few states are rejecting these cuts and increasing taxes to keep their vital services functioning.

Kentucky has yet to make that decision. In fact, the legislature and the people have yet to face up to the problem. The administration has. The picture is bleak. Our choices are stark: make substantial cuts to many state programs or increase revenue, or a combination of the two.

Governor Patton knows that the administrative costs of existing programs have been cut all they can be cut without affecting existing commitments of the General Assembly. He also realizes that the ultimate decision to cut back on existing commitments rests with the General Assembly. That is the reason his staff has made every effort to keep existing programs running until the General Assembly came into session to debate the alternatives. The Governor believes very strongly that decisions made by the legislature should only be changed by the legislature unless there is no alternative. By the end of March the General Assembly will have made the decision of going forward or going backward.

The Governor realizes that many members of the General Assembly believe that the budget can be cut without hurting services. Those members of the General Assembly who espouse that position have an obligation to prepare a balanced budget using current revenue and make the public aware of the implications of such a budget. When such a budget is exposed in its entirety, the public will reject it and they should. A budget can always be cut, but cuts should not be made without first discussing the impact those cuts will have on our citizens and their futures.

Many legislators want to protect education. The Governor shares that desire. However, it is almost impossible to exempt education and then make the drastic cuts in the rest of government which would then be required. There is no realistic way to stop the growth of our human services expenses. No one in Kentucky is going to allow children to go without someone to care for them. No one in Kentucky is going to allow sick and elderly people to be neglected and go without care. No one in Kentucky is going to support turning away severely retarded people who can't take care of themselves and have no one to care for them. The people won't stand for it and the courts won't allow it. Courts in many other states have prohibited them from cutting back Medicaid and other vital human services. The same will almost certainly happen in Kentucky should we try.

The cost of social and human services programs will continue to grow. The increasing costs of this program will impact our ability to increase funding for education. In fact, that has happened during Governor Patton's administration.

No one could dispute Governor Patton's passion for education or his effort to increase funding for education. During a period when inflation has been 19 percent, he has increased funding for education by 29 percent, a real increase of 10 percent. And in every budget he has prepared, he has instructed his budget staff to limit the increase of the Medicaid program to inflationary growth. Despite the administration's best efforts to control expenses, in 7 years Medicaid costs have increased 63 percent; 9 percent a year; 44 percent more than inflation. That is a lower growth rate than most states. Despite the best efforts of the next administration, the cost of our human services programs will continue to grow at the expense of education.

When times were good Kentucky acted very responsibly. We added to our Budget Reserve Trust Fund. We refunded \$287 million of taxes previously collected under laws the courts declared invalid. The money had been spent in previous administrations. We made one-time investments in needed community infrastructure. We upgraded the state's business management infrastructure. And we cut taxes in 26 different ways, saving Kentucky taxpayers over \$2 billion since 1995. In FY 04 alone, the savings will be \$485 million and that figure will grow in future years. The time has come to restore that revenue and secure Kentucky's future.

This report contains the Governor's recommendation on how the \$520 million of additional General Fund revenue and \$53 million in additional Medicaid Trust Fund revenue needed to fund current commitments can be generated and discusses several parts of Kentucky's tax code that should be changed. Some changes would increase revenue; some would decrease revenue. These needed changes will solve the state's fiscal crisis in the short run and prevent or mitigate similar situations from arising in the future.

The Governor is proposing comprehensive tax reform with the increases in revenue needed to secure Kentucky's future.

BACKGROUND

In a previous report, *An Assessment of Kentucky's Fiscal Condition* (the *Assessment*), the administration documented the financial crisis the Commonwealth faces and outlined the stark choices available to Kentucky policymakers.

In that report the administration made several important statements which are summarized below.

1. Over the past seven years, 26 tax cuts have been implemented with a total savings to Kentucky taxpayers of \$485 million in FY 04. Cumulatively these savings will total \$2.72 billion through FY 04.
2. A strong economy from FY 95 through FY 00 permitted Kentucky to maintain adequate government services while implementing the tax cuts. The changes in the economy in FY 01, FY 02 and FY 03 and the tax cuts have permanently reduced state government revenue in the range of \$500 million a year for the foreseeable future while the commitments of state government have not been reduced. The Commonwealth must now reduce current commitments or restore the lost revenue.
3. In FY 04, the cost of KERA-related new programs will be \$263 million more than the KERA-related tax increases will generate, primarily because revenue from corporate citizens has not met expectations.
4. Corporate support for state government has decreased from \$355 million (ten percent of the General Fund) in FY 90 to \$325 million (five percent) in FY 02, a decrease of 8.6 percent, even though the top Corporate Income Tax rate was increased from 7.25 to 8.25 percent (a 13.8 percent increase) in 1990 to help pay for KERA. If corporate support for state government were restored to ten percent, the increased revenue would be \$359 million in FY 2004. During this same time period, individuals increased their support for state government by 123 percent and the Sales and Use Tax Revenue (paid by individuals and businesses) increased by 112 percent.
5. From FY 96 through FY 02 the Commonwealth has experienced dramatic growth in the cost of the criminal justice system (74 percent) and Medicaid (63 percent) and modest growth in support of education (29 percent) while holding the increase in the cost of the rest of government to 13 percent, even though inflation has grown 19 percent. Since 1998, the first year of postsecondary education reform, funding for postsecondary education has gone up 20.8 percent. Enrollment has gone up 22.2 percent.

6. In response to the revenue shortfall, the administration cut budgeted expenditures in FY 02 for postsecondary education and Medicaid two percent and the rest of government five percent, exempting only K-12 education. Considering the continually increasing demands of KERA and the "Leave No Child Behind" federal legislation, the administration believes that any cut in K-12 education will slow Kentucky's progress towards having an education system where all schools are performing at the proficient level by 2014.
7. To refute the claim that overspending and government inefficiency is the cause of our current fiscal problem, the *Assessment* reports the results of the "EMPOWER Kentucky" initiative to improve government efficiency approved by the 1996 session of the General Assembly. This initiative, the most far-reaching and successful reengineering of state government in the nation during the 1990s, has produced documented savings of \$572.4 million from FY 97 through FY 04 and will produce \$92.0 million of recurring efficiencies in FY 04.

The essence of "EMPOWER Kentucky" is to improve efficiency through better business systems, redesigned work procedures and improved employee training. This initiative is one reason the total workforce in the executive branch declined 1,133 employees from the day Governor Patton took office until December 3, 2002. This workforce reduction is in addition to the 1,844 employee reduction which occurred during the previous four years. The current program of reducing administrative costs another \$30 million by December 2003 includes another workforce reduction of 1,000 employees through attrition.

Kentucky's school reform efforts are at a critical juncture. We are asking our teachers to do more but our teachers' salaries have fallen from 27th best in the nation in 1992, to 34th in 2002. In a soon to be released report prepared for Governor Patton, the need for new resources to meet the goals of KERA by 2014 is estimated to be approximately \$420 million in FY 04 compared to FY 03 with further increases over the next two biennia. Other adequacy studies underway are reported to be coming to a similar conclusion.

Our colleges and universities are experiencing the same problems. They are exceeding the expectations of House Bill 1 of the 1997 Extraordinary Session but we aren't funding the incentives we developed to precipitate change.

Our future depends on education and we must continue to improve it, not reduce it.

THE CURRENT SITUATION

In January of 2002, the administration presented a biennial budget proposal to the 2002 session of the General Assembly. At that time, it appeared that the Commonwealth could adopt a very sparse two-year continuation budget to weather the economic downturn and then resume a normal revenue growth path to address the increasing needs of our society. In the regular 2002 session, each house passed a version of that budget but a final budget did not pass. On April 22, 2002, the Governor called an Extraordinary Session of the General Assembly to enact a budget. The Governor again proposed a biennial budget which was introduced as House Bill 1. This proposal was \$145.4 million more than the original budget proposal because of additions by the General Assembly during the regular session.

Everything contained in House Bill 1 as introduced in the Extraordinary Session had been approved by either the House or the Senate during the regular session. Almost everything in House Bill 1 except funding for the gubernatorial election was approved by both chambers in the Extraordinary Session. The administration acknowledges that House Bill 1 is not a legislatively enacted budget but it has been implemented in FY 03 by the administration as our best guide to determining the will of the General Assembly. For purposes of simplicity, this report will refer to House Bill 1 as the state budget.

House Bill 1 Budget Does Not Expand State Government

House Bill 1 contained no new commitments and fell far short of a budget which would have kept Kentucky moving forward. It did not advance the educational and other social needs of a progressive society.

Governor Patton said in his Budget Address announcing his original budget that it did not move us forward but it also didn't take us backwards. It kept our promises for the current biennium and held out hope for renewed progress in the next biennium. Things have changed. We have the resources to implement House Bill 1 in FY 03; we do not have enough revenue to fund House Bill 1 in FY 04. In view of the prolonged economic slowdown, it is now doubtful that we can resume moving forward in the next biennium or even the next.

FY 2003-2004 Revenue Shortfall

After the Consensus Forecasting Group revised the revenue estimates for FY 03 and FY 04 downward in November of 2002, the administration projected that resources available to finance the FY 03 budget would be \$144 million short (2.1 percent) and the resources available to finance the FY 04 budget would be \$365 million short (5.2 percent).

A December update of that analysis, using the latest information on the shortfall in K-12 education and all the resources which could be identified to get through FY 03, revealed a shortage of resources of \$98.0 million in FY 03 (1.4 percent) and \$398.5 million in FY 04 (5.5 percent).

In early January the Consensus Forecasting Group was asked to again review the forecast for FY 03 and FY 04 so budget deliberations would be based on the most updated information available. They realized that in the first half of FY 03 the Commonwealth received some extraordinary one-time revenue from tax amnesty, the Inheritance Tax and Sales and Use tax and unusual payments from the Lottery . These nonrecurring revenues have brought revenue closer to the original estimate for FY 03. Additional one-time resources have been identified which will fund House Bill 1, including the shortfall in the K-12 education budget, in FY 03. However, increased costs occasioned by the bad economy have necessitated programmatic reductions in the Corrections and Medicaid programs to keep them in line with the appropriations in House Bill 1 for FY 03. In FY 04 resources available will be \$444 million (5.9 percent) short of the funds necessary to fully fund House Bill 1 including the shortfall in the K-12 education appropriation and the cost overruns in the Corrections and Medicaid programs.

There is no debate about the ability to cut the budget in FY 04 enough to run state government on the resources available. The debate is about the price our people will pay if we make those cuts. There are lots of different ways and places to reduce expenses. All will adversely affect services. The Governor has decided that he cannot support cuts of the magnitude necessary to live within existing resources. To do so would be to advocate that Kentucky take a step backwards. Instead, the Governor will support a comprehensive reform of our tax code that will keep us competitive with our neighboring states and increase revenue enough to fund all our existing commitments.

The administration has recently taken additional measures to reduce spending all across state government by imposing restrictions on hiring, overtime, contracting for services, travel, purchases of equipment and fixtures, utilities, and state vehicles. These cost-saving measures are a continuation of the cost-cutting efforts which began with budget reductions in FY 01 and continued through FY 02. These actions, directed by Executive Order in December 2002, are estimated to save \$30 million from all fund sources by the end of the Patton Administration and further reduce the state workforce by 1,000 employees.

The administration has utilized every resource available to keep the commitments of the General Assembly as reflected by its past actions. This has required operating the state with a structurally unbalanced budget, something the Governor opposes as a matter of fiscal policy but a measure the administration has been forced to take in its efforts to carry out the mandates of the General Assembly. The administration has also had to use reserves in dedicated use funds like the Petroleum Storage Tank Assurance Fund, the Kentucky Access Health Insurance program, The Kentucky Economic Development Finance Authority, and the Road Fund just to maintain essential services.

Governor Supports Restoring Revenue

The Governor will propose a budget which will require new revenue in the range of the \$573 million, just a little more than the tax cuts implemented during his administration. This report proposes specific revenue measures to generate the needed funds.

The Governor is opposed to any further significant cuts in state services; however, the administration will provide the General Assembly information about the effect of any spending cuts the General Assembly may propose while at the same time opposing those cuts. The administration has already provided the General Assembly with an analysis of the effect of an across-the-board 5.2 percent cut in FY 04. The administration has also made it very clear that it does not support those cuts.

No matter where cuts of the magnitude needed to enact a budget with no new revenue are made, these cuts will make any progress during the first term of the next governor extremely difficult. It will take at least four years of revenue growing faster than inflation to bring support for current state services back to the level existing before the cuts.

House Bill 1 Does Not Fund Kentucky's Long-Term Needs

House Bill 1 will not meet the long-range needs of Kentucky. It was a stopgap measure to bridge what was then thought to be a temporary downturn in state revenue which turned out to be a permanent reduction of state resources. Some of the measures used to balance that proposal will have long-term adverse consequences for Kentucky.

The continuing use of funds from the Petroleum Storage Tank Assurance program means that the clean-up of leaking fuel tanks will be delayed to some distant future date. The \$30 million being taken out of the Road Fund to help fund the state police means that some roads authorized by the General Assembly will not be built. If we continue to take money out of the Kentucky Access Health Insurance Fund, the already authorized assessment against health insurance premiums may have to be increased.

There are some expenses not budgeted in House Bill 1 which will have to be made even if they aren't budgeted. There is no provision to fund Necessary Government Expenses¹ (NGE). These expenses will be incurred no matter what the budget appropriation is. And perhaps as important as any other shortcoming of House Bill 1, there is no provision to rebuild

¹ Certain expense items are so hard to estimate that the General Assembly has authorized the executive to spend whatever is needed. Items frequently submitted for payment as NGE include costs of fire suppression; FEMA matching funds (typically for floods); other natural disaster aid such as tornadoes; unbudgeted costs of federal and state judicial decisions; and National Guard activation costs for special events. These funds have always come from surplus or unspent balances in various appropriations. The current budget is so tight that these sources will likely not be available in FY 04. The budget should anticipate some expenses in this category and then authorize the executive to spend whatever it takes to do the job. If the appropriated amount is not enough, the additional funds are paid as a NGE. The point is that the money will be spent if necessary and to not include a reasonable appropriation in the budget just doesn't reflect reality.

the Budget Reserve Trust Fund, a fundamental element of sound fiscal management. Corrections and Medicaid are severely under funded in House Bill 1 and there is no funding for a continuation of our program to invest 6 percent of our income in essential infrastructure.

If we are going to make Kentucky government fiscally sound in FY 04 and beyond, we must address these other expenses not addressed in House Bill 1.

Funds Needed to Sustain Progress

Table 1 identifies the recurring expenditure needs of Kentucky government in addition to the expenditures appropriated in House Bill 1 if Kentucky State Government is to meet the commitments which have been made to our citizens.

Nothing in a budget which funds all the additional expenditures listed in Table 1 will represent an expansion of Kentucky State Government's commitments. A budget increase of this magnitude will not address the needs of K-12 education to meet the goals of KERA by 2014, nor will it fund the commitments of our postsecondary education reform movement.

The following is an explanation of some of the items in Table 1.

1. Department of Education Shortfalls:

The budget establishes a Basic SEEK per pupil in average daily attendance appropriation (\$3,149 in FY 03; \$3,234 in FY 04) and then appropriates the money estimated to be required to fund it. The total appropriation will always vary from the amount needed to fully fund the Basic SEEK appropriation. This pupil in average daily attendance appropriation is the figure on which local school districts build their budgets. In most recent budgets the total appropriation has exceeded the amount needed to fully fund the pupil in average daily attendance appropriation.

In the past, this surplus was shared in whole or in part with the local school districts. Unfortunately, the total appropriation in FY 03 is \$48.6 million short of that needed to fund the pupil in average daily attendance appropriation and in FY 04 it is \$78.1 million short. Unless the total appropriation is increased by these amounts, school districts will not receive the money they need to fund their budgets. The result will be that school districts will have to cut expenditures because of a budget cut from the state.

2. Department of Corrections Shortfalls:

The Department of Corrections in November 2002 estimated that it would have a budget shortfall of \$6 million in FY 03 and \$11 million in FY 04. This shortfall was caused by a felon population which was growing beyond the projected levels funded in House Bill 1. The administration has taken action in the form of an early release program of nonviolent and nonsexual offenders to bring expenditures in FY 03 in line with the funds budgeted in House Bill 1. The Governor has suspended the early release program

TABLE 1

AMENDMENTS TO HB 1 REQUIRED TO CONTINUE CURRENT COMMITMENTS AND RESTORE FISCAL ADEQUACY TO KENTUCKY

Fully Fund HB 1 Budget Plus Shortfalls in K-12 Education, Corrections and Medicaid, Continue Capital Investment Program, Provide Funding for Necessary Government Expenses, and Begin to Rebuild the Budget Reserve Trust Fund (\$Millions)

	FY 03	FY 04
Revenues		
Beginning Balance	\$ 23.49	\$ -
Consensus Forecasting Group Estimate of January 2003	\$ 6,862.50	\$ 7,038.30
Fund Transfers	\$ 194.84	\$ 60.24
Other Revenues	\$ 11.45	\$ (4.75)
Total Existing Resources	\$ 7,092.28	\$ 7,093.79
Expenditures		
Expenditures in HB 1, Legislative Budget and HB 3 (Judicial)	\$ 7,144.81 *	\$ 7,407.15
Less Campaign Finance Funds	\$ (7.00)	\$ (2.00)
Less Adjustments for Coal Severance Programs, Other & Debt Service		\$ (16.84)
Less Adjustments for Administrative Savings	\$ (3.75)	\$ (15.00)
Net Required General Fund Expenditures	\$ 7,134.06	\$ 7,373.31
Additional Expenditures Required to Meet Commitments		
Necessary Government Expenses	\$ 15.00	\$ 15.00
K-12 Education	\$ 48.58	\$ 78.08
Fully Fund Corrections Budget	\$ 2.25	\$ 9.50
Medicaid**		\$ 40.80
Revenue Cabinet Implementation Costs for Tax Proposal (non-recurring)		\$ 2.00
Debt Service for Capital Investment Program		\$ 40.76
Appropriation to Budget Reserve Trust Fund		\$ 50.00
Total Additional Funding Needs	\$ 65.83	\$ 236.14
Total Expenditures Required	\$ 7,199.89	\$ 7,609.45
Budget Shortfall	\$ 107.61	\$ 515.66
Less Additional One-Time Funds Identified***	\$ 107.61	\$ -
New General Fund Revenues Required	\$ 0.00	\$ 515.66
New Revenues Needed to Increase Medicaid Trust Fund**		\$ 52.90
Total New Revenues Required		\$ 568.56

Notes:

* Does not include planned ending balance of \$57.73 Million anticipated in Executive Spending Plan.

** To fund \$136 Million of the \$216 Million Medicaid Shortfall in FY 04 anticipated when HB 1 was proposed in 2002. The remaining \$80 Million of the shortfall will be funded by a proposed increase in revenue to the Medicaid Trust Fund by increasing the Provider Tax on Nursing Facilities and ICFMRs from 2% to 6%. At present the Administration believes Medicaid expenditures can be held to this level with no additional cuts beyond those announced 1/16/03.

*** \$107.61 Million of One-Time Funds plus use of the Budgeted Ending Balance of \$57.73 Million Equals a Total of \$165.34 Million One-Time Resources Applied to Shortfall.

to give the legislature an opportunity to adequately fund the Department of Corrections budget. The current estimate of the additional funds which will be needed is \$2.25 million in FY 03 and \$9.5 million in FY 04.

3. Medicaid Program Shortfall:

The Medicaid budget is currently estimated to be approximately \$450 million short by the end of FY 04. The administration is taking programmatic actions to reduce expenditures within the program to bring the deficit back to \$216 million, the amount which was projected when the Executive Budget was introduced in January 2002. The administration is proposing that the provider tax on nursing facilities and intermediate care facilities for the mentally retarded (ICFMRs) be increased from 2 percent to 6 percent, resulting in both increased capacity for fiscal relief in those service areas and a reduction in the overall deficit in the Medicaid program.

4. Capital Investment Program. The Patton Administration has emphasized from day one the need to have a consistent capital investment program to continually upgrade and modernize the infrastructure of state government, our schools, colleges and universities and our local communities. This investment needs to be in the range of 6 percent of the state's recurring revenue. Assuming that the additional \$573 million in new revenue is realized, the Commonwealth can support an additional \$525 million of bonded indebtedness to fund infrastructure investment. The debt service will be \$40.8 million on the additional General Fund-supported investment the Governor is proposing.

Any budget with substantially less than \$573 million of new revenue will, in the current biennium or shortly thereafter, result in a cut in services which have been authorized by the General Assembly to be provided by Kentucky State Government.

Governor Calls for Public Debate

The Patton Administration believes that Kentucky's leaders need to engage in a comprehensive debate on both sides of the issue; budget cuts and new revenue.

The administration has made all the significant administrative cuts it can make without seriously impacting service delivery to Kentuckians. Further cuts to the budget will affect public policy decisions that the General Assembly has made and programs the General Assembly has specifically mandated. The Governor believes that if these programs are going to be permanently cut, the General Assembly should make that decision. The administration has asked the leaders of the General Assembly to begin a dialogue about which services they would prefer to reduce or eliminate.

It is obvious that cuts in expenses would be the preferred course of action. But legislators and the people need to know the effect of those cuts. The administration has already addressed the problem of shortfalls in the Corrections budget and the Medicaid budget. Just about

everybody has criticized our actions there. The problem is that no one has suggested an alternative. The Executive doesn't have the luxury of being opposed to something but not having to solve the problem. In the end, the General Assembly doesn't either.

The administration believes very strongly that this crisis can only be averted with sincere dialogue between the Governor, the House leadership and the Senate leadership. The Governor has asked for that dialogue to begin.

The other side of the debate is increased revenue, which the Governor supports. Here again the administration realizes that it has the responsibility to establish the starting point.

The administration continuously analyzes the state's tax code to find ways to improve it. This document is published to share with the General Assembly and the people of Kentucky the knowledge, opinions and insights we have gained as a result of our years of experience and our study of the tax code.

THE ELEMENTS OF A GOOD TAX CODE

The Governor believes that we should use this crisis to address the entire General Fund revenue-generating system² of the Commonwealth with the goal of answering the following questions.

1. Is the revenue generated adequate to meet the needs of Kentucky?
2. Is it fair to our citizens, both individuals and businesses?
3. Does it generate a stable stream of revenue to fund the consistent nature of government expenditures?
4. Does it grow as our economy and the needs of our society grow?
5. Are we competitive with those states which compete with us for economic expansion?

This document discusses the major elements of our tax code from the perspective of these five questions.

Guiding Principles

As we consider our tax code we should agree on certain broad principles to guide us as we decide what we want our tax code to do. The Governor believes that a state tax system should have the following characteristics:

1. Be broad based, covering many areas of the economy and not overly dependent on any one sector.
2. Be fair, although fairness is in the eyes of the beholder. For a hundred years or so, progressive taxation based on overall income has been generally seen to be the most fair; those who have benefited more from being members of our society should pay progressively more of their income to support the society. Kentucky overall has a relatively flat tax structure, being somewhat regressive on the low-income end; however, not as regressive as some other states.
3. Be easy to administer and collect. Over the years, piecemeal amendments to our tax code, generally to address a special issue or a special interest, have made our code fairly complex.

²In general, except for the portion dealing with the Road Fund and the Medicaid Trust Fund, revenue as used herein refers to the General Fund. Exceptions will be noted.

4. Produce a stable stream of revenue because state government expenses go down slowly when times are good but they go up substantially when times are bad. Increased stability must be a fundamental goal of comprehensive tax reform.
5. Produce revenue which grows on average and over time at about the same rate as the state's economy.

Over the long run, as a society gets more complex, commonly needed services such as education need to be increased and society may need to devote a larger percent of its total production to the common good through government. Certainly we need a proportionately larger state government now than we did one hundred years ago.

The most commonly used measure of economic growth is total personal income. In FY 95, the total of state and local taxes in Kentucky was 11.9 percent of personal income, very close to the national average. An exceptionally strong economy caused state revenue to soar. We began to cut taxes. By FY 99 (the last data available), our total tax burden was down to 11.1 percent of total personal income. We have reduced the amount of our personal income spent on government by 6.7 percent. Had it remained at 11.9 percent, \$485 million of additional revenue would be available in FY 04.

The fact is that government revenue in Kentucky has not grown as fast as our economy and yet our need to expand education, public protection and social programs has grown. Growth consistent with the growth of our economy must likewise be a fundamental goal of comprehensive tax reform.

6. Be adequate to keep Kentucky competitive with services needed by a strong society. Adequacy is subjective but as a minimum it must be sufficient to fund existing commitments. In fact, an adequate revenue stream is one which meets the needs of a growing economy. A growing economy will develop new needs.
7. Keep us in a competitive position for economic growth relative to our neighboring states. This principle has been applied to every recommendation in this report. The recommended increases in tobacco taxes and corporate taxes and the recommended decrease in motor vehicle taxes have been derived by comparing our competitive positions relative to our neighboring states, particularly our primary competitors – Tennessee, Illinois, Indiana and Ohio.

KENTUCKY'S CURRENT TAX CODE

A review of the various elements of Kentucky's General Fund revenue generating system is a central focus of this report. The General Fund is made up of several different taxes which have different growth and stability characteristics. The following is a discussion of our major revenue streams and some of the problems with them. Our system is relatively broad based but the increased growth of the Individual Income Tax as a percent of total General Fund revenue raises a concern that we are becoming too dependent on this one source. The dramatic decline of corporate tax revenue as a percent of the General Fund is also a cause for concern.

In most of the discussions, changes are recommended which will increase or decrease revenue. The estimate of the change in revenue is for FY 04, assuming that the change is in effect for the entire fiscal year. Should the General Assembly make the recommended changes, the period of time they would be in effect will be different than FY 04. Therefore, the revenue actually realized in FY 04 will be different from the amounts contained in this report.

Individual Income Tax

The Individual Income Tax is our largest source of revenue and is more volatile than the Property Tax and the Sales and Use Tax but less volatile than the Corporate Income Tax.

Graph 1 portrays the characteristics of Kentucky's revenue from this source from FY 81 through FY 06 (FY 03-06 estimated). This source of revenue mirrors the economy. It declines during recessions and increases during boom times. Kentucky has become more and more dependent on this revenue stream over time as the graph line depicting the percentage of total revenue attributed to the Individual Income Tax illustrates.

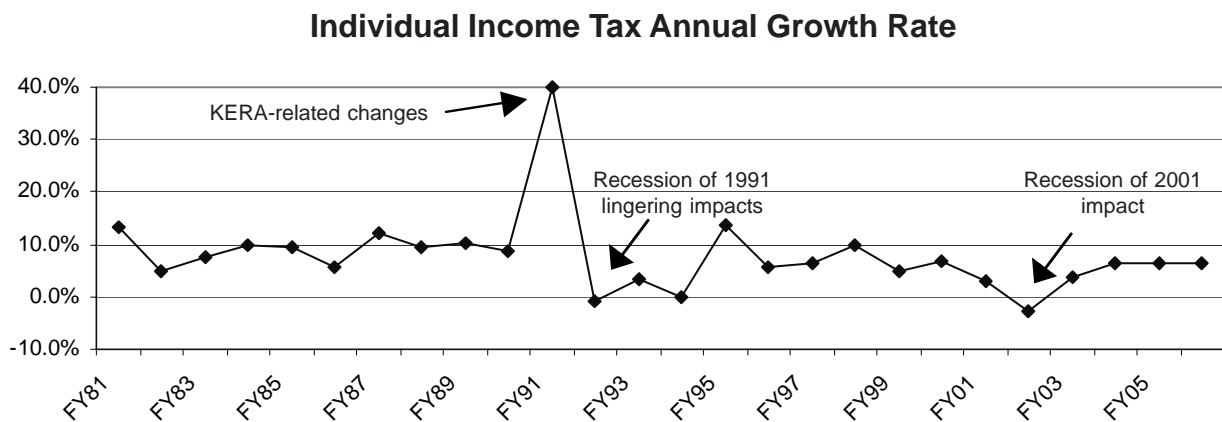
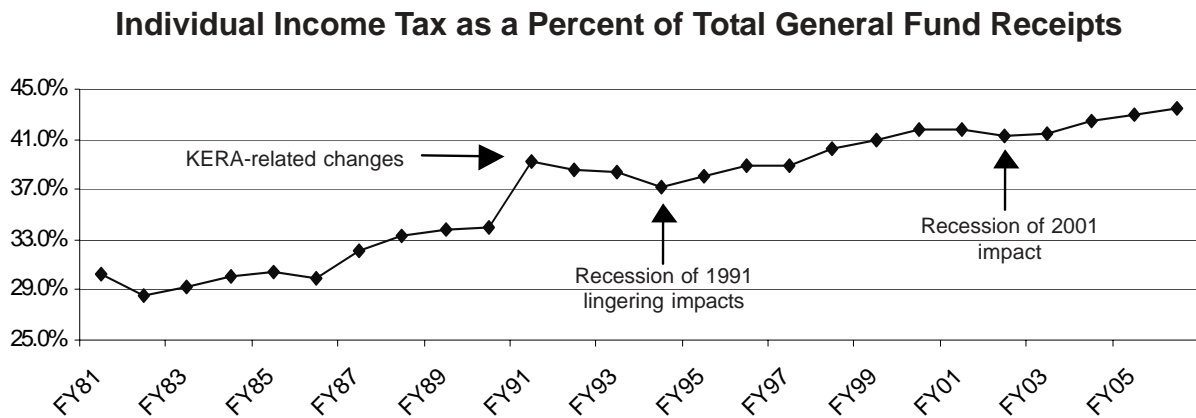
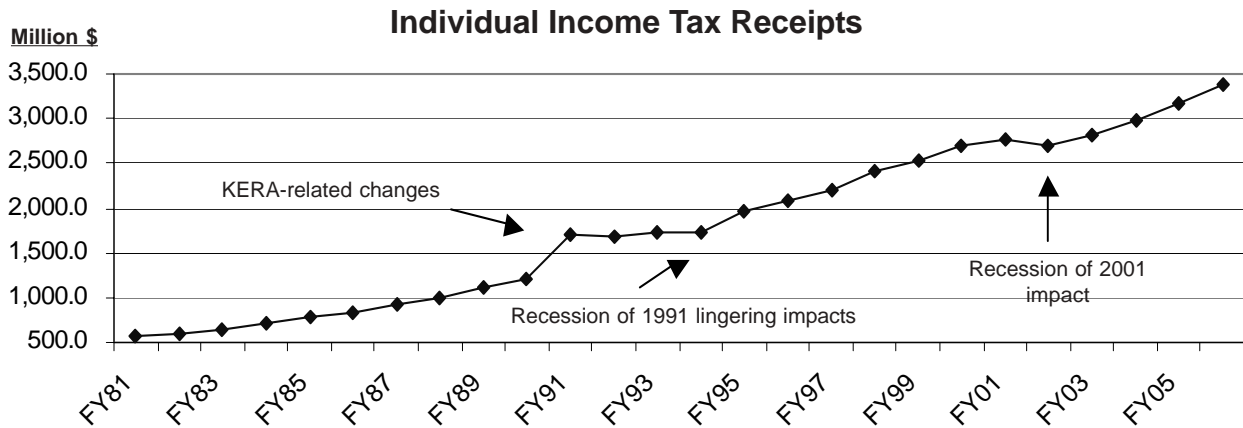
The volatility of this revenue source is illustrated on the graph of the growth rate. Note that the growth of this revenue source was near zero in FY 92 and FY 94 but it was 2.7 percent below the previous year in FY 02, an unprecedented decline in this revenue source.

Low-Income Tax Credit

The most significant problem with the Individual Income Tax is the effect on workers at or near the federal poverty level. As discussed in the *Assessment*, Kentucky's overall tax burden on lower-income Kentuckians is a higher percentage than the tax burden on the rest of our citizens. To partially remedy this inequity, Kentucky's low-income tax credit program should be modified so that the Individual Income Tax on low-income citizens will be reduced.

The Governor's proposal is to eliminate the Individual Income Tax on families with a modified gross income of up to 100 percent of federal poverty guidelines (FPG). Additional relief would be provided to family units making more than 100 percent of FPG. This tax reduction would phase out at 123 percent of FPG for a family of one and at 164 percent of

GRAPH 1 Individual Income Taxes



Note: Actual FY81-FY02 ♦ Forecasted FY03-FY06

FPG for a family of four or more. To be eligible for the targeted relief, the taxpayer must maintain a household, may not be a dependent of another taxpayer, and must file a joint return if married.

Another problem with our current low-income tax credit program is that it applies to taxpayers who have a high total income but a low taxable income. Our proposal would change the current low-income tax credit program to determine eligibility based on the modified gross income. By using a modified gross income, the unintended benefits of the current low-income credit to higher income families are avoided.

These changes will remove from Kentucky's tax rolls more than 175,000 individuals and families who are taxed under current law. More than 85,000 additional individuals and families will owe less than under current law.

These changes will reduce revenue by \$31 million in FY 04.

Tax-Exempt Retirement Income

A second revision which should be considered is a phaseout of the tax exemption on retirement income for high-income retirees. The cap (currently \$39,400 for tax year 2003) would be reduced dollar-for-dollar by any income over the cap. For example, if an individual's total income was \$59,400, the \$20,000 over the cap of \$39,400 would reduce this individual's cap to \$19,400, so only \$19,400 of pension income would be tax exempt. If the individual's total income was \$78,800, the \$39,400 above the cap would reduce the excluded amount to zero so this person would have no retirement income tax exempt. It should be noted that state employee retirement income earned before the 1995 law changes cannot be taxed and would be exempt no matter what the person's income. Farmers' income from Phase II tobacco settlement proceeds and The Tobacco Loss Assistance Program is also tax-exempt and would continue to be.

No doubt senior citizens, who will most likely have high medical costs, deserve some extra consideration on tax burden. But this is going to be an increasing component of our society and the current blanket exemption on all retirement income without regard to other income is simply not fair. To think that struggling middle-class families trying to buy a home and educate children should pay the full rate on income and the wealthiest person in Kentucky should save \$2,364 a year on taxes just because some of their income is from retirement sources is unconscionable. These changes will generate \$75 million in FY 04.

Deduction of Income Tax Paid to Foreign Governments

A major part of the KERA changes to the Kentucky Individual Income Tax Code was the elimination of the deductibility of the Personal Income Tax paid to our federal government from our adjusted gross income.

If we can't deduct the tax paid to our own federal government, we cannot justify the deduction of income tax paid to a foreign government. The administration proposes to close this loophole. This measure should generate \$3.4 million in FY 04.

Sales and Use Tax

The Sales and Use Tax is Kentucky's second largest source of revenue. Graph 2 portrays the characteristics of Kentucky's revenue from this source.

Characteristics of the Sales and Use Tax Revenue

The Sales and Use Tax revenue as a percentage of the General Fund revenue has risen over the years, but not as much as the percentage of the Individual Income Tax. It has been a more stable source of revenue than Individual or Corporate Income taxes.

The stability of this revenue source is illustrated by the annual growth rate. Note that this revenue source has never had a decline (a growth rate less than zero) from the previous year. This demonstrates the relative stability of this revenue source, even in times of economic decline.

A Sales and Use Tax is viewed by some people as regressive but many of the exemptions from the Kentucky Sales and Use Tax like food, residential utilities and most prescription drugs tend to make it less regressive than many other states' Sales and Use Tax.

Many people view it to be fair – everyone pays. It is easy to understand. Few people could make an accurate estimate of the amount they pay annually in Sales and Use Tax. The Sales and Use Tax is one of the least offensive taxes we pay.

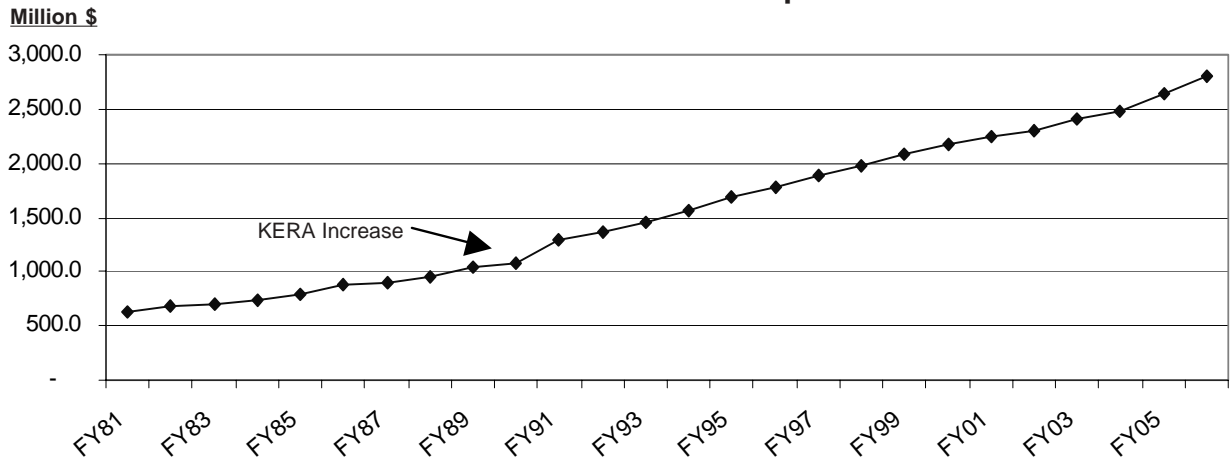
Sales and Use Tax Applied to Services

There is strong sentiment in some quarters to extend the Sales and Use Tax to services and Kentucky officials have considered that. Other states have tried to tax some services with little success. Many major services such as legal, accounting and financial consulting can be performed out-of-state where the tax would be difficult or impossible to collect. Kentucky suppliers of these services would be at a 6 percent competitive disadvantage. Since few other states tax these kinds of services, it would be very hard to do in Kentucky.

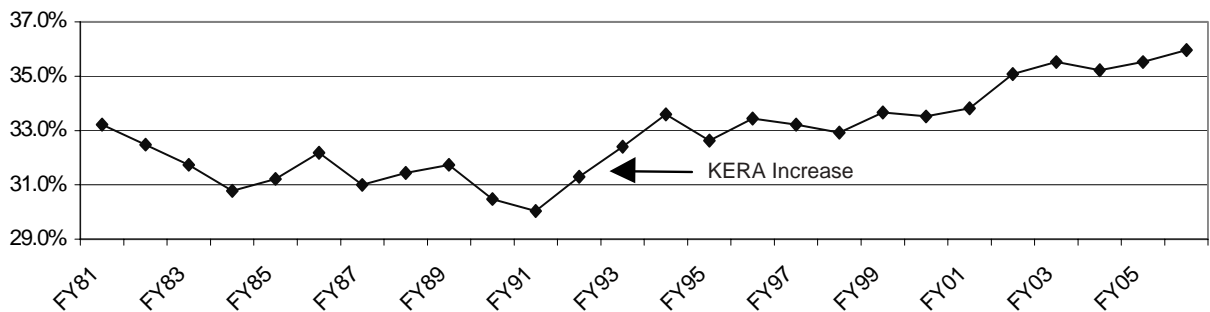
Taxing the labor on repairs sounds simple but it could cause businesses to change their business practices by doing more repairs in-house where the labor would not be taxed instead of outsourcing it as many companies presently do. We could, however, consider expanding the base of this tax to include such services as laundry and dry cleaning, car washes, participatory admission fees, extermination and pest control and similar services which cannot be easily exported.

GRAPH 2 Sales and Use Taxes

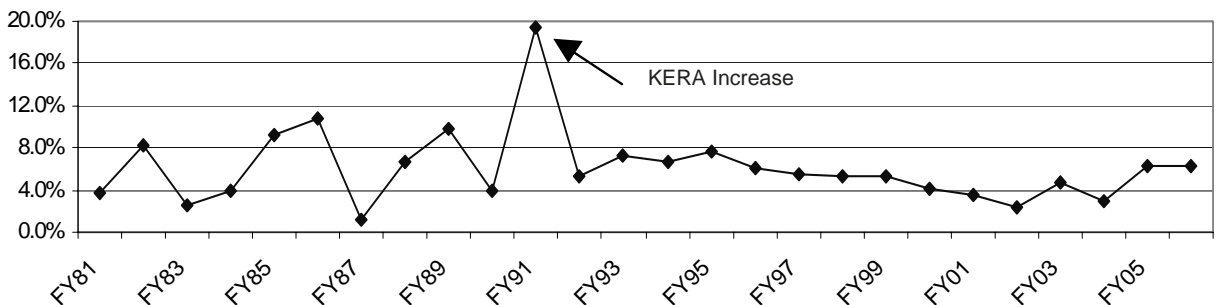
Sales and Use Tax Receipts



Sales and Use Tax as a Percent of Total General Fund Receipts



Sales and Use Tax Annual Growth Rate



Note: Actual FY81-FY02 ♦ Forecasted FY03-FY06

Extending the Sales and Use Tax to services which should be considered and the revenues which would be realized are:

	<u>\$ Million</u>
• Laundry and Dry Cleaning, Linen & Uniform Services	15.3
• Janitorial Services, Carpet and Upholstery	17.9
• Exterminating and Pest Control	3.9
• Participatory Admissions Fees	8.2
(golf, bowling, skating, amusement park rides)	
• Car Washes	3.5

All of these changes will generate \$48.8 million in FY 04.

Sales and Use Tax Applied to “Unbundled” Natural Gas Service

Prior to deregulation, natural gas was purchased from a local distributor. If the purchaser was nonresidential, the Sales and Use Tax was applied to the sale price of the natural gas which included transmission and distribution; that is, all the costs were “bundled” together. With deregulation, these different elements of getting natural gas to the customer can be “unbundled” and purchased from different vendors.

A consumer can now purchase natural gas from a supplier in another state, have it transported by a pipeline transmission company and delivered to the consumer by a local distributor, the only regulated vendor left in the supply chain.

Under current law, only the natural gas is taxable in the “unbundled” environment; the transmission and distribution is exempt. If the natural gas is purchased from an out-of-state provider, then the delivering utility cannot be required to collect the Sales and Use Tax (even though the natural gas is still subject to the tax).

The state is unable to require an out-of-state vendor to collect the Sales and Use Tax from the Kentucky purchaser because the vendor has no nexus³ in Kentucky.

In fairness to customers who purchase “bundled” natural gas and pay tax on the transmission and distribution, the law should be changed to restore the tax to the total cost and require the in-state distributor to collect the tax on the natural gas, the distribution and the transmission just as they do for the sale of “unbundled” natural gas.

This change would generate \$6 million in FY 04.

³Nexus for Sales and Use Tax purposes means having enough presence in Kentucky to be required to collect the Sales and Use Tax for Kentucky. Nexus for Corporation Income and License Tax purposes means having enough presence in Kentucky to be required to pay taxes in Kentucky. Most states define nexus as doing business in the state. For corporate taxes, Kentucky has the most stringent definition of any state: a physical presence. Therefore, if a company has no nexus in Kentucky (no physical presence in Kentucky), it cannot be required to pay tax to Kentucky. The Governor’s proposal will define nexus as doing business in Kentucky, just as most other states do.

Impose Sales and Use Tax Collection Responsibility on Dot.com Affiliates of Companies with Kentucky Nexus

This proposal would expand Kentucky's current Sales and Use Tax nexus standards to require Dot.com affiliates of companies that currently have a physical presence in Kentucky to collect Kentucky's Sales and Use Tax from their Kentucky customers. This will include those affiliates that accept returned merchandise for a refund or credit and those who provide exchanges of the merchandise that their customer previously purchased from the company's remote affiliate (e.g., on-line, catalog, phone orders). This change would generate \$5 million in FY 04.

Property Tax

The Property Tax is the third largest source of state revenue. This revenue stream includes property tax on real estate, tangible and intangible property. The rates on different kinds of property vary.

Property taxes are the most visible taxes we pay and are therefore the most disliked.

Characteristics of the Property Tax

Graph 3 portrays the characteristics of Kentucky's revenue from this source.

The graph shows that the percent of the state General Fund financed by the property tax has declined from 9.5 percent in FY 81 to 6.6 percent in FY 02.

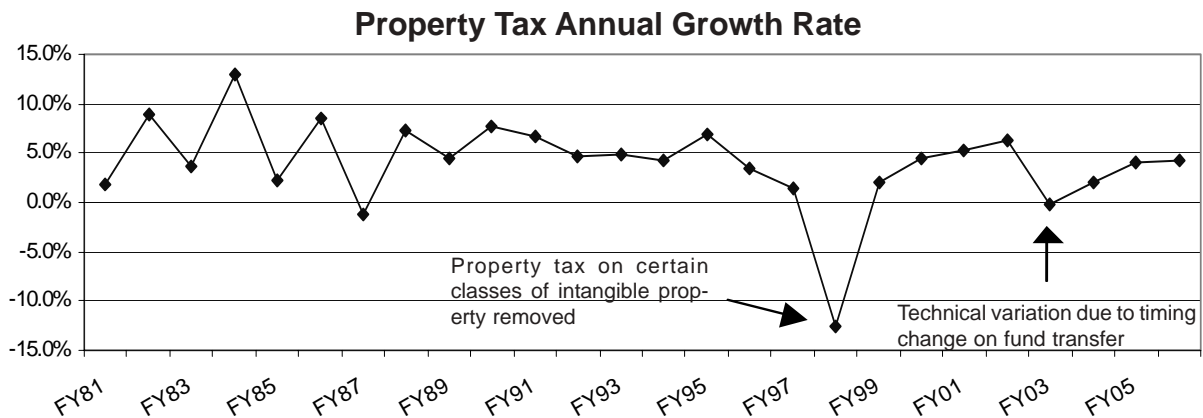
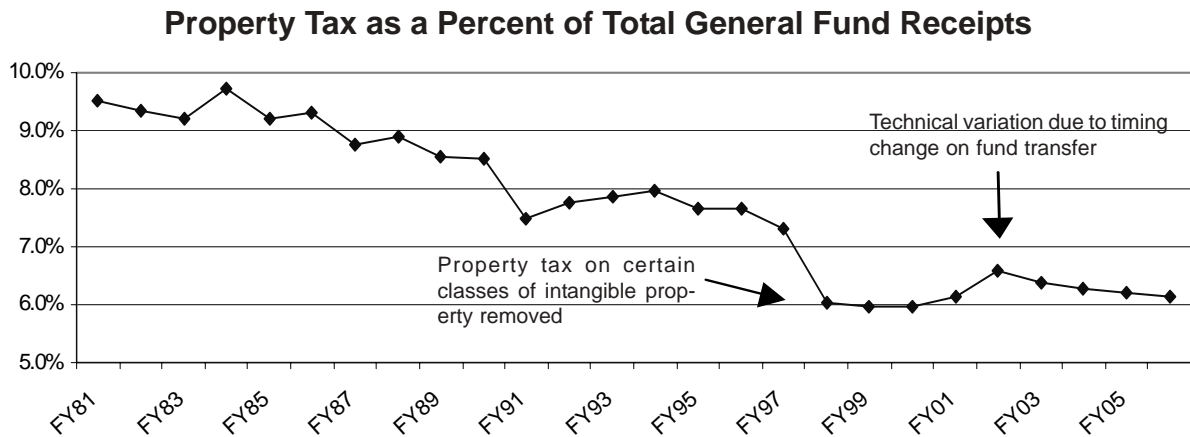
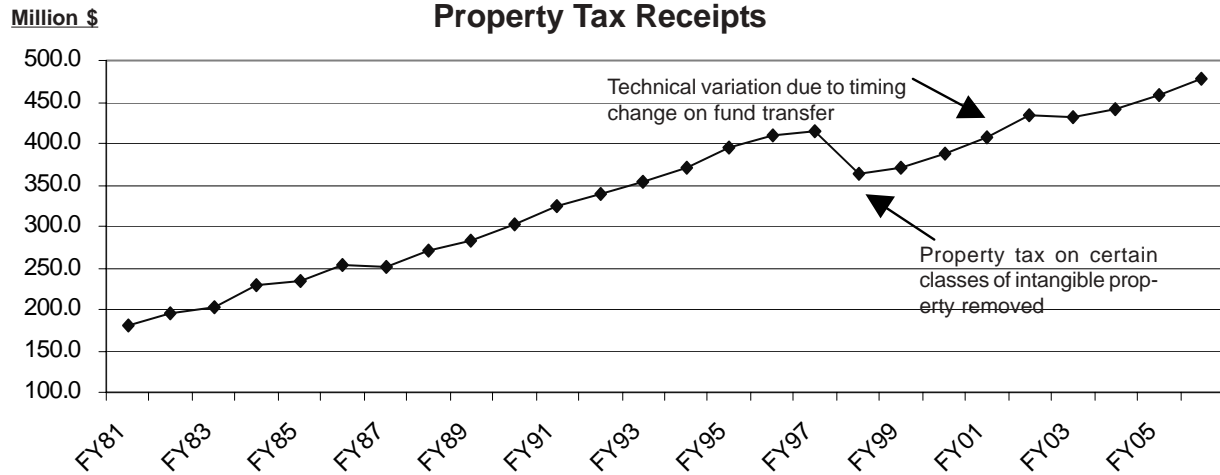
The annual growth rate graph shows the volatility of this revenue source. Note that this revenue source has not had negative growth since 1987 except as a result of the elimination of the tax on most intangible property in 1997.

A property tax is generally one of the most stable major sources of tax revenue. This stability is because the value of property (at least as it is assessed by a property valuation administrator) doesn't change very much from year to year and with real estate, the value almost always goes up over time.

Property Tax on Real Estate

House Bill 44 was enacted in Extraordinary Session in 1979 in response to the high rate of inflation in the 1970s. It limited state revenue growth from the property tax on real estate to 4 percent per year, regardless of the increase in value of real estate and regardless of increases in the construction of real property in Kentucky. House Bill 44 has slowed the growth of the property tax as a revenue source.

GRAPH 3 Property Taxes



Note: Actual FY81-FY02 ♦ Forecasted FY03-FY06

It has resulted in a decline in the state real property tax rate from 31.6 cents per one hundred dollars of valuation in 1978 to 13.5 cents in 2002, a decline of 57 percent. The Governor proposes to stabilize the state property tax rate on real estate at the present rate of 13.5 cents per 100 dollars of property value. There will be a \$4.8 million increase in revenue in FY 04 but the real advantage of this change will be future growth which will help our overall growth of tax revenue mirror the growth of our economy.

Property Tax on Intangible Property

Another reason for the slow growth of property tax revenue over the past 12 years is the removal of the intangible tax on several classes of intangible property as a result of a court decision in 1997. The Governor proposes to remove the remainder of this tax on intangible property such as bonds and accounts receivable. Since few other states tax these kinds of assets and since about one-half of this tax is borne by business and the rest by individuals who invest in the future of Kentucky, this would be one more improvement in the business climate in Kentucky. This change would save these taxpayers \$33.5 million in FY 04.

Property Tax on Motor Vehicles and Watercraft

One property tax that is particularly offensive is the state property tax on motor vehicles and watercraft. Only five states have a state property tax on motor vehicles and, of the five, Kentucky's is the highest. None of our neighboring states have this state tax and many Kentucky cars are licensed in other states, causing us to lose not only the property tax but also the 6 percent Motor Vehicle Usage Tax on the sale of motor vehicles and watercraft. The Governor proposes to repeal the state property tax on motor vehicles and watercraft. Local property taxes on motor vehicles and watercraft would remain. This change will save taxpayers \$83.5 million in FY 04.

Corporate Taxes

Direct taxes on corporations are the fourth largest source of state revenue. The two major taxes directly attributable to the corporate community are the Corporate Income Tax and the Corporate License Tax. The Administration acknowledges that businesses pay Sales and Use Tax, Property Tax and perhaps some other taxes and fees just like individuals do. This report does not intend to imply that the two corporate taxes discussed at length are the only taxes businesses pay. The intent is to demonstrate that the relative share of support for state government borne only by corporations and the relative share borne by individuals has changed dramatically since 1990, the year we all committed ourselves to better education.

The purpose of the Kentucky Corporate Income Tax and the Kentucky Corporate License Tax is to provide a vehicle for corporations to support the government they are depending on for basic services. These are the two taxes we (and most other states) have adopted to ensure that corporations pay their fair share of the cost of state government.

This source of revenue has declined dramatically relative to our other sources of revenue because we have created several loopholes which permit and even encourage businesses to organize themselves in ways which minimize or even totally eliminate their tax liability in Kentucky.

The problems with Kentucky's revenue stream cannot be fixed unless there is a major change in the way we tax corporate citizens.

Characteristics of Corporate Taxes

Graph 4 portrays the characteristics of Kentucky's revenue from the corporate community. The graph portrays rather dramatically that this source of revenue is declining as a percent of total General Fund revenue and in fact has actually declined \$30 million from FY 90 to FY 02. The graph also shows that this is by far the most volatile major source of revenue with many years of negative revenue growth.

Corporate Income Tax

The Corporate Income Tax in Kentucky is 4 percent of the first \$25,000 of income, 5 percent of the next \$25,000, 6 percent of the next \$50,000, 7 percent of the next \$150,000 and 8.25 percent of the remainder of corporate income which is apportioned to Kentucky.

If a corporation's entire operation is in Kentucky, all of its income is taxable here. We have approximately 22,000 c-corporations⁴ that do business only in Kentucky. Most of them are very small.

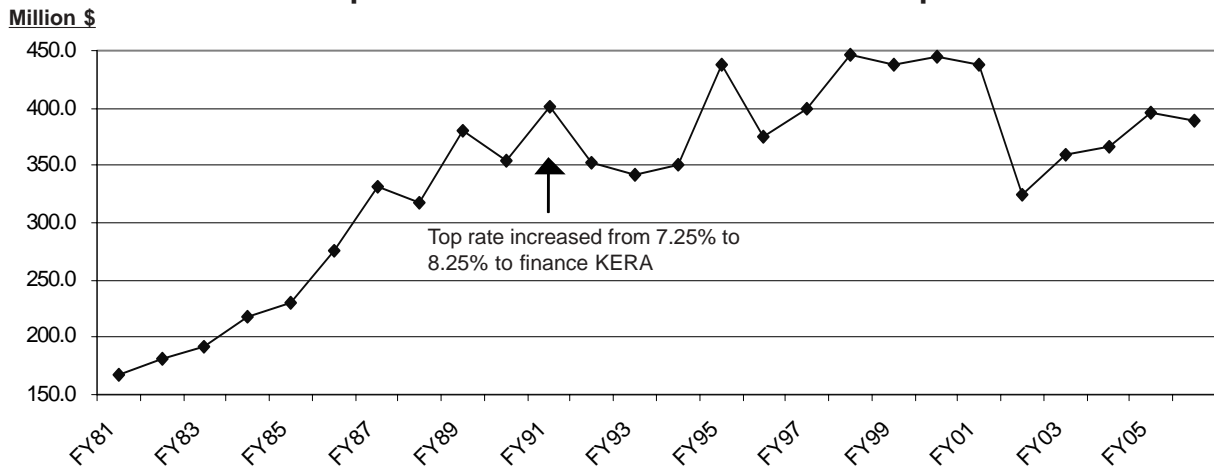
If a corporation has operations in one or more other states, it files its corporate tax as a multi-state corporation. We have about 15,000 of these corporations. A multi-state corporation's income is apportioned to Kentucky using a three-factor formula applied as follows:

1. Twenty-five percent of the total corporate income is apportioned to Kentucky according to the percent of the corporation's total payroll which is in Kentucky.
2. Twenty-five percent of the total corporate income is apportioned to Kentucky according to the percent of the corporation's total capital employed in Kentucky.
3. Fifty percent of the total corporate income is apportioned to Kentucky according to the percent of the corporation's total sales in Kentucky. A typical national company would normally have only about one and a half percent of its sales in Kentucky so almost half of its income is off limits to Kentucky taxes.

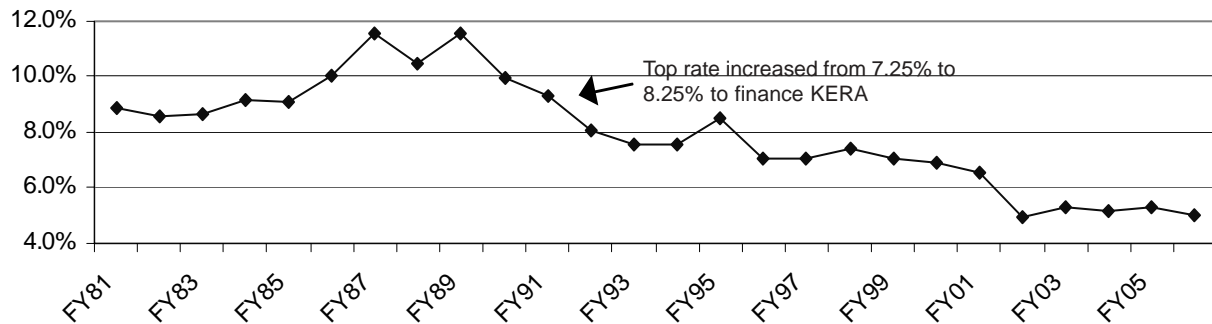
⁴C-corporation will be explained on Page 46.

GRAPH 4 Corporate Income and License Taxes

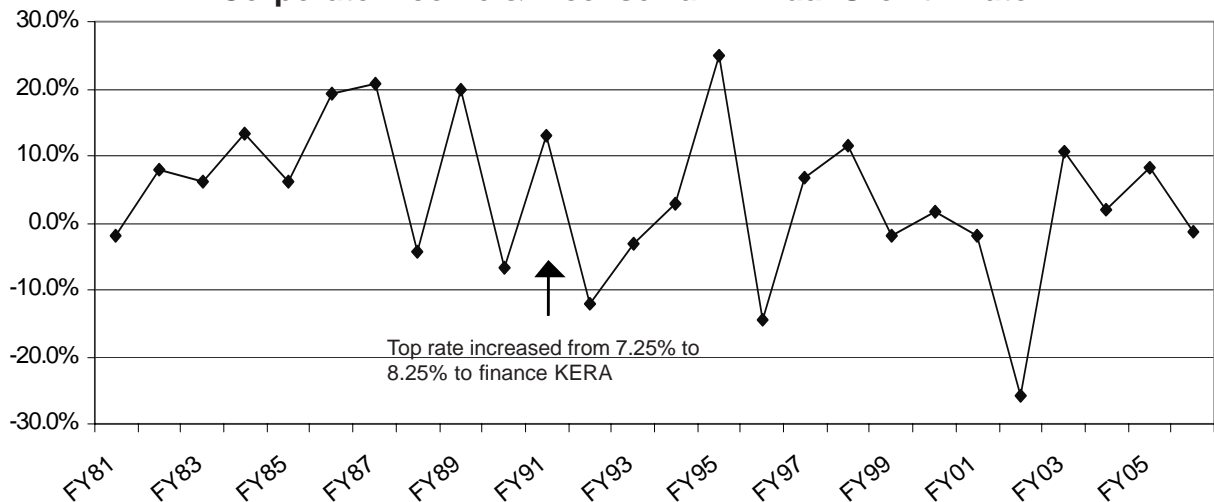
Corporate Income and License Tax Receipts



Corporate Income & License Taxes as a Percent of Total General Fund Receipts



Corporate Income & License Tax Annual Growth Rate



Note: Actual FY81-FY02 ♦ Forecasted FY03-FY06

This calculation may seem relatively simple but when a corporation having nexus in Kentucky is owned by another corporation that in turn may be owned by another corporation and perhaps another, some of which do not have nexus in Kentucky, determining which corporation actually earned the income is nearly impossible. These related companies transact a lot of business between themselves. One related company may supply the goods sold by the retail company. One related company may supply administrative services to the retail company. One related company may supply intellectual services to the retail company.

Our auditors have the authority to ensure that transactions between related companies are at a fair market price but how can we know how much a transmission built in Europe should cost. To use this authority, our auditors would have to first determine that a transaction is not at “arm’s length,” then embark on the more difficult task of calculating to what extent it is not at arm’s length. Our only practical tool to ensure compliance is trust.

Since corporate income is directly and disproportionately affected by the business cycle, this is by far the most volatile major revenue stream coming into our General Fund.

The top rate on the Corporate Income Tax was raised from 7.25 percent to 8.25 percent in 1990 as a part of the tax increase to pay for KERA. This seems to have had no impact on the steady decline of this revenue stream as a percent of the General Fund.

Corporate License Tax

The Corporate License Tax is designed to ensure that a corporation pays some tax to support state government, even in years it does not show a profit. For most corporations, the rate is 21 cents per \$100 of “capital employed” in the business. “Capital” is defined as capital stock, surplus, advances by affiliated companies, intercompany accounts, borrowed moneys or any other accounts representing additional capital used and employed in the business. Current accounts and funds borrowed to pay for inventory are exempt.

This should be a very stable and growing source of revenue for the General Fund but corporate conversions to business structures which are exempt from the Corporate License Tax have severely eroded this source of revenue and this erosion is continuing. This subject will be discussed more thoroughly later in this report.

Summary

The Governor proposes to restore business support for state government to the 10 percent it was in 1990 when several taxes, including the Corporate Income Tax, were raised to pay for better schools. This change is designed to generate \$340 million in additional revenue in FY 04.

Other Taxes

Various other taxes, fees and miscellaneous revenue made up the remaining 12.2 percent of state revenue in FY 02. Significant among these are the lottery, the severance tax, the cigarette tax and the tax on alcohol products.

Characteristics of Revenue from “Other” Taxes

Graph 5 portrays characteristics of Kentucky's revenue from “other” taxes and revenues. The graph shows that the growth of this revenue stream in recent years has not equaled that of the Individual Income Tax or the Sales and Use Tax or even the Property Tax. It has grown better than the revenue from corporations.

Taxes on Alcohol

The Governor has mentioned that we should consider applying the sales tax to alcohol not consumed on the premises. Further review of the way this product is taxed revealed that Kentucky was losing a lot of the Sales and Use Tax on alcohol products sold in Kentucky because of widespread illegal vendors who did not collect or remit the Sales and Use Tax. To remedy this situation, in 1982 the legislature repealed the 5 percent Sales and Use Tax and replaced it with a 9 percent Excise Tax at the wholesale level where it could be more easily collected.

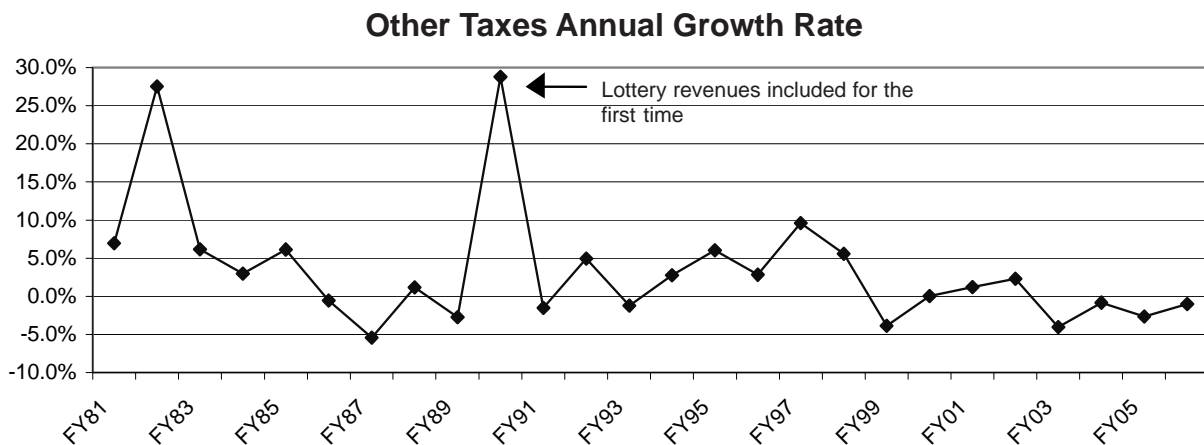
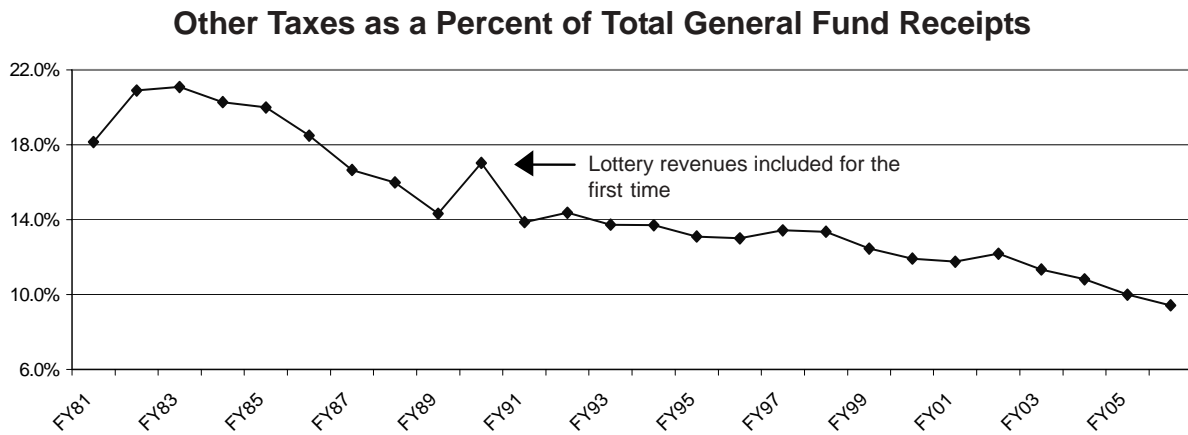
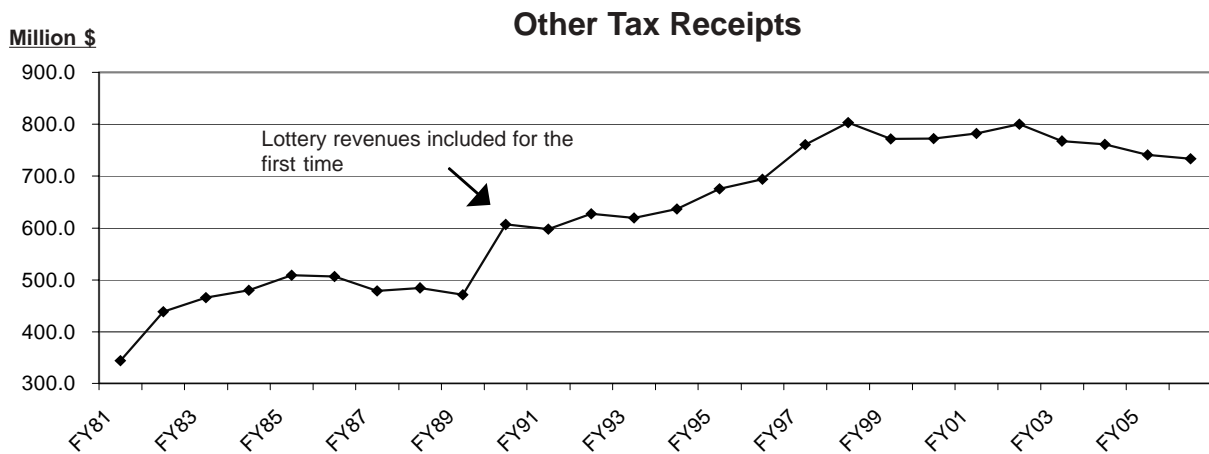
A comprehensive analysis of how we tax alcohol products determined that Kentucky is competitive with neighboring states and there should be no increase in revenue from this source. We should, however, consolidate the seven taxes and fees on alcohol at the wholesale level into one tax at a percentage rate for simplification and efficiency. The rate would be 14 percent on distilled spirits, 10.75 percent on beer, and 11.6 percent on wine. This change would be essentially revenue neutral, but should save the state and the industry some red tape.

Tobacco Taxes

The importance of tobacco as a mainstay of the agricultural economy in Kentucky has virtually prohibited the taxation of tobacco products in the Commonwealth, a tax which has been a substantial source of revenue in the vast majority of our sister states. In the past the taxing of tobacco products in Kentucky has been viewed as an attack on the tobacco farmer. The time has come to get beyond that mentality.

Tobacco is a product which has declined as a staple of the Kentucky farm economy and will continue to do so. To think otherwise is to imitate the ostrich. That is not to say that tobacco is not important to Kentucky agriculture. It is and it will continue to be so for years to come.

GRAPH 5 Other Taxes



Note: Actual FY81-FY02 ♦ Forecasted FY03-FY06

Kentucky Has Supported Our Tobacco Farmers

No state has demonstrated as much support for the tobacco farmer as has Kentucky. Without Governor Patton's personal and effective advocacy for the nation's tobacco farmers during the negotiations with the tobacco companies on the Phase II program, there would be no Phase II program. And his personal presence as the only governor at the table when the Phase II money was divided between the tobacco-producing states ensured that Kentucky's tobacco farmers got the most favorable division of the proceeds as they could possibly have gotten.

When the appropriation of the Phase I funds was decided by the Kentucky General Assembly, it was Governor Patton providing the leadership, along with a few members of the General Assembly, that won the dedication of 50 percent of the Phase I funds to the promotion of Kentucky agriculture; a commitment that no other state has come close to equaling.

Governor Patton and the Kentucky General Assembly have demonstrated by their actions that they recognize and appreciate the unique contribution that tobacco has made to our economy and culture. Tobacco, more than any other product, has been responsible for maintaining the family farm as a viable economic entity in Kentucky. Our leaders have done all they can do to preserve the opportunity for future Kentuckians to have the family farm experience.

An increase in the tax on tobacco products would not be an attack on the Kentucky tobacco farmer. It would be an attempt to prevent a movement to use the tobacco settlement proceeds to solve a part of the state's fiscal problem, an action the Governor will vigorously oppose.

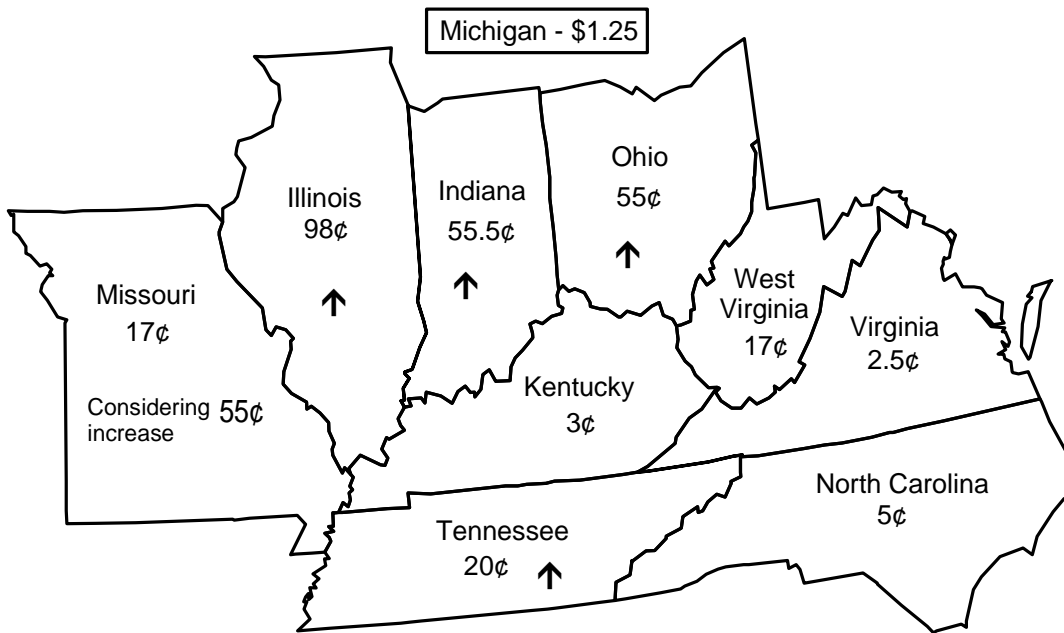
Tobacco Users Will Pay

The time has come to realize that those who use tobacco products should pay their fair share of the cost that the use of those products imposes on Kentucky society. An increase in the cost of tobacco products may reduce the consumption of these products in Kentucky, resulting in a long-term decline in the cost of healthcare related to tobacco use. The benefit from reduced healthcare expenditures will far exceed the increased cost of tobacco products. The possible decrease in the use of tobacco in Kentucky as a percentage of national consumption would be minuscule and therefore a resulting decrease in the production of tobacco in Kentucky would be imperceptible. This question is entirely a matter of reality versus emotion.

Average Tax in Contiguous States

The tax on cigarettes could be increased 37 cents per pack and still keep Kentucky very competitive. Figure 1 portrays the cigarette tax rates in our neighboring states. The average of our four main competitors is 57 cents, right at the national average. Even counting Virginia's 2.5 cents (which is under serious discussion in Virginia as is the 17 cents in West Virginia), the average of our seven contiguous states is 38 cents.

FIGURE 1
Comparison of Cigarette Excise Tax Rates
July 2002
(cents per pack)



National Average -- 58¢ per pack

Source: Tax rates as posted on <http://www.tobaccofreekids.org>

The arrows indicate that four of our surrounding states have raised their cigarette tax within the past two years.

Governor's Proposal

Increase the tax by 37 cents per pack and apply a 13 percent excise tax on other tobacco products. Kentucky has no excise tax on "other tobacco products" such as cigars, pipe tobacco, chewing tobacco and snuff. Forty-seven states do, including all of our surrounding states except Virginia. This action will increase revenue by \$167.4 million in FY 04, taking into account that sales would decrease slightly.

Taxing Electricity Exported From Kentucky From Merchant Power Plants

The administration supports the use of Kentucky coal to produce electricity to be exported out of the state. The use of Kentucky coal has great economic value to the most distressed parts of the Commonwealth. At the same time, the burning of coal in Kentucky adds to our air pollution. If these plants are located correctly, this additional air pollution will not materially degrade our environment. We should, nevertheless, be compensated for this degradation through a General Fund excise tax.

There is an even more important reason to apply a tax to merchant electricity generated by natural gas. Kentucky gets virtually no benefit from these facilities. The natural gas is imported and generates no sales tax revenue for the state. The jobs created after construction are minimal. The property taxes at the local level can be significant if they have not been abated by local governments but they create no more revenue for the state because of House Bill 44.

The air pollution from these facilities is minimal but there is no reason that Kentucky should not realize some revenue because we are ideally suited geographically. A state should utilize any natural advantage it may have, be it warm weather, coastal harbor or central location. Kentucky's advantage is our central location. Let's use it.

A tax of \$0.001 per kilowatt hour will generate \$1.4 million in FY 04.

Taxes on Public Service Communications Companies

Generally speaking, public service companies are businesses which provide essential services such as water, sewer, electricity, telephone, natural gas, transportation and similar services that might otherwise have to be provided by government. These companies are, or have been, regulated by the state as to how much they can charge for their services and how much profit they can make. There has been a lot of discussion about the way we tax public service communications companies in Kentucky. The Governor proposes to address this issue and to mitigate some apparent inequities.

The taxation of public service companies in Kentucky has a long history. Since these companies provide what are considered to be essential services, it was determined long ago that all citizens should be given equal access to these services, even if they are geographically located in such a way as to require additional or excessive costs on behalf of the providers to make that service accessible to them. Consequently, these companies were given rights not given to other competitive companies such as the right of eminent domain in order to obtain rights of way so that they could provide these services and the right to make a guaranteed reasonable profit.

In addition, they were given geographic monopolies to enhance their ability to generate a profit even when their cost to provide these services to all of the people in their service area was more than if they provided the service only to those who were the most economical to serve. They were also guaranteed a set rate of return on their investment through a regulated rate-setting mechanism. Uniform rates were set for all customers so that the lower-than-cost charges to the high-cost customers would be offset by the higher-than-cost charges paid by low-cost customers.

Because these companies were given rights other competitive companies did not enjoy and because the property of these companies crossed jurisdictional lines, it was difficult to assess the property tax on a local level as was done with most other competitive companies. Most companies (bricks and mortar) are taxed on the value of their hard assets which are

normally located in a fixed location. However, public service companies are taxed on a unit value or business enterprise method. As long as these companies were regulated and enjoyed a monopoly status and a guaranteed profit, this method was not objectionable.

Public service companies which are in the communications industry (all forms of telephone service, cable service, etc.) have been deregulated and they find themselves in direct competition with non-public service companies such as direct broadcast satellite (DBS) television. Public service communications companies are being taxed differently from the non-public service companies with whom they directly compete and they feel this places them at a competitive disadvantage. There is no doubt that taxing one company at its "enterprise" or "unit" value and taxing a competing company's hard assets derives a very different result.

One advantage that current public service communications companies enjoy is an exemption from the corporate license tax. Because the unit or enterprise valuation method was designed to value and tax not only the hard assets but also the value of the company as a going enterprise, those companies were exempted from the Corporate License Tax. Treating these companies similar to their competitors would require removing them from the public service Property Tax statutes and placing them in the Corporate License Tax statutes. They would then enjoy all the privileges and responsibilities of the companies with whom they directly compete. This removes the controversy regarding the franchise value. It makes them subject to the Corporate License Tax (if they are corporations).

In order to overcome the problem of unequal property tax treatment between jurisdictions, the tangible property of these communications companies should be centrally assessed by the Revenue Cabinet and either billed and collected centrally or certified to the local jurisdictions for billing at that level. Either solution would place all competitive communications companies on an equal footing with their direct competition as far as Property Tax is concerned.

Uneven and Unfair Taxation

Property tax is not the only inequity faced by communications companies. These companies are a very diverse group comprised of cable television, direct broadcast satellite (DBS), telephones including wireless, and any provider of two-way voice service, video service, or any combination of communications services. There are many different providers of similar services and some are taxed very differently from others. Each segment believes that any tax it pays that its competition doesn't pay is unfair. The following is just a sampling of the different ways we tax this industry.

1. The Sales and Use Tax is applied to telephone service but not to cable or DBS service.
2. Most local jurisdictions impose a 3 percent Franchise Tax on cable businesses and telephone companies except they cannot apply this tax to BellSouth, because it is

exempt from a local Franchise Tax because it is a descendant of Bell Telephone. This exemption was granted by state government sometime in the 19th century to encourage Bell Telephone to extend service to rural areas of the state.

3. Most cable companies pay a local Franchise Tax that the DBS companies do not pay.
4. They all say we apply the Property Tax to them unfairly.
5. Telephone companies, which pay Sales and Use Tax on the “switch access charges” they pay to other phone companies claim that when they resell the service, their customers are double taxed.

All of them have valid complaints.

School Taxes

KERA requires school districts to have a minimum property tax rate of \$0.35 per \$100 or the equivalent revenue derived in whole or in part from three other sources: a Utility Gross Receipts License Tax of up to 3 percent; an Occupational License Tax of up to 0.5 percent (counties with at least 300,000 inhabitants may levy an additional 0.25 percent); or an excise tax on individual income limited to 20 percent of a taxpayer’s state Individual Income Tax liability.

Most school districts do substitute some of the local revenue they are required to generate from the local property tax by imposing the Utility Gross Receipts License Tax on public service communications companies. This is not a Sales and Use Tax but it is calculated on the gross receipts derived from the provision of the service and is listed as a separate item on the customer’s bill.

Two school districts, Jefferson County and Anchorage Independent, do not impose this tax but they do impose the occupational tax.

Cable companies say, “We pay a 3 percent Franchise Tax and collect the 3 percent Utility Gross Receipts License Tax. That equals 6 percent so we should continue to be exempt from the 6 percent Sales and Use Tax telephone companies collect on their service.” In one way of looking at it, that does make them equal to BellSouth, Kentucky’s largest telephone company, at least in Jefferson County, which has no Utility Gross Receipts License Tax and no Franchise Tax on BellSouth. However, this ignores the fact that almost all of their other wired telephone competitors also collect the 3 percent Utility Gross Receipts License Tax and pay the Franchise Tax in addition to the 6 percent Sales and Use Tax so the cable companies may have a 6 percent advantage over those telephone companies.

Complicated is an understatement.

These businesses in general say that they just want to be taxed like any other business, on the value of their physical property. But that would require them to pay the Corporate License Tax, if they operate as corporations. Few of them want to pay this tax.

It is obvious that the way we tax public service companies in the communications industry is outmoded because these deregulated companies are in direct competition with non-public services companies.

This system of taxation should be repealed. To do away with the present system could cost the state and many local jurisdictions a lot of money, depending on how it is done.

A Fair Way to Tax Communications Companies

Let us walk through a “fair” system that puts everybody on a level playing field from the standpoint of what the state has done and should do.

First, we should value the companies’ physical property where it is located and put it on that local jurisdiction’s tax bill, just like most other businesses.

Second, we should apply the six percent Sales and Use Tax to everybody in the communications industry equally (except DBS service which will be discussed later). These two actions raise \$ 37.5 million for the state in FY 04⁵.

Let’s examine the cable companies’ case against collecting the Sales and Use Tax. They say they probably already pay a school Utility Gross Receipts Tax and a Franchise Tax that generally equals the 6 percent Sales and Use Tax paid by telephone companies. The Governor’s response is, the Utility Gross Receipts Tax is a school tax that is collected from the people in that school district. The decision to levy it in lieu of another tax, such as the Occupational License Tax or the Property Tax, is a local decision. Why should the state try to use the state tax code to equalize a tax difference made by a local decision? The administration believes it is fair to apply the state Sales and Use Tax equally to all communications services (with the exception of DBS).

The question then becomes what about the local Franchise Tax that BellSouth doesn’t pay? Again we must ask, does the state have a responsibility to redress a local inequity caused by a decision made over a hundred years ago?

The cable and telephone providers also say that this proposal would perpetuate the competitive disadvantage that satellite providers have on them when they all provide the same service. They may be right. The disadvantage is at least 3 percent; some could argue 6 percent. We recommend a 9 percent excise tax on DBS services in lieu of making this

⁵ This is the “new” money from applying the Sales and Use Tax to cable.

service subject to the Sales and Use Tax to partially equalize the tax burden borne by cable, telephone and DBS. This will increase revenue \$21.2 million in FY 04.

Switch Access

As a result of AT&T's divestiture in 1984, existing telephone companies which have switches and lines going to almost every home and business in the Commonwealth maintain their own transmission networks but must provide access to these networks on a cost basis so other businesses can compete with them and not have to duplicate the physical facilities. This results in charges from one provider to another for the use of their facilities. This charge to move a call from one network to another is often referred to as a "switch access" charge.

In the mid-1980s the Revenue Cabinet determined that Kentucky law required providers to collect Sales and Use Tax on these switch access services. The purchasers claimed this was a wholesale transaction exempt from the tax. However, Kentucky law does not provide an exemption from the tax due to a "resale" of services. In 1998, the Revenue Cabinet agreed to not push the issue to give the 2000 session of the General Assembly a chance to clarify the law. In that session, the administration proposed to address the inequities of the way Kentucky taxes communications services as a part of comprehensive tax reform. That measure did not pass.

The Revenue Cabinet has been collecting this tax, including the end-user access fee, since June of 2000. It produces about \$26.3 million a year. The administration proposes to repeal this tax on switch access as a part of its overall proposal to take all communications services providers out of the classification of public service companies. One of the results of this reclassification is that these companies will now be subject to the Corporate License Tax. Subjecting all communications companies to the corporate license tax would equalize them with other types of competitive companies.

To summarize the results of taxing the communications industry just like any other business, as described in this report, the results in FY 04 would be:

	Million \$	
	State	Local
Property Tax	-8.9	-17.2
Sales and Use Tax		
Apply tax to cable industry	+37.5	0
Repeal tax on switch access	-26.3	0
Nine Percent Tax on DBS	+21.2	0
Expand Corporate License Tax	+10.0	0
TOTAL	+33.5	-17.2
 NET NEW REVENUE	 +16.3	

With any change to this taxing system the local jurisdictions must be held harmless. This can be accomplished by establishing a base for every local jurisdiction now receiving revenue from the present Property Tax system. This base could be on the revenue received in FY 02 or perhaps a three-year average. Each year the state will adjust that base by some factor (CPI) and send a check from the state for that amount to each jurisdiction to replace the revenues previously received from these companies.

The hold-harmless program for cities and counties occasioned by the state takeover of the judicial system in 1976 is an example that can be used as a precedent. At that time some communities made money from their local court system. The state to this day sends those communities a check to compensate them for the lost revenue.

TYPES OF BUSINESS ORGANIZATIONS

A fundamental purpose of the Governor's proposal is to stop the loss of revenue from businesses which use, in a completely legal and honorable way, the tax loopholes we have created to permit them to avoid taxes. In order to understand how businesses can use our existing laws to legally reduce tax burden, an explanation of the various types of business organizations operating in Kentucky and how they are taxed must be presented.

Historically, there were three principal forms of business ownership; sole proprietorship, partnership and corporation. The primary reason for selecting a particular business form was for ease of doing business or for legal protection from liability for losses the business might incur.

Sole Proprietorship

A Sole Proprietorship is a business owned by one person. That person does not have to register with the Secretary of State and is personally responsible for the debts of the business. The business pays no taxes except what the individual owes.

General Partnership

A General Partnership (GP) is an agreement between two or more "persons" to engage in a business. A "person" can be an individual, a corporation or another partnership. No filing with the Secretary of State is required and every partner can act for the partnership and is personally liable for the debts of the partnership. The partnership as such does not pay Kentucky Corporate Income Tax or Corporate License Tax. The partners pay taxes on their distributive share of the profits. One of the most common historic uses of the GP is to provide professional services like legal, medical, accounting or engineering.

The great disadvantage of operating a business as a Sole Proprietorship or a GP is that if something happens that causes the business to lose a lot of money, the owner is liable for that debt. When an individual becomes involved in a business venture organized as a Sole Proprietorship or a GP, they risk everything they have.

Stock Corporations

A stock corporation is a business organization that is separate and apart from its owners. It is formed by filing Articles of Incorporation with the Secretary of State and has the same powers as an individual to do all things necessary to carry out its business. The Corporation issues shares of stock which can be purchased by individuals or other businesses including partnerships and other corporations. The stockholders have no authority to act on behalf of the Corporation but they do have the right to elect a board of directors who manage the company. The stockholders have the right to receive the profits of the Corporation as dividends. The stockholders are not liable for any of the debts of the Corporation beyond their investment.

The corporation has been the traditional method to protect the owners of a business venture from all liability. The protection of the stockholders from any debt of the corporation is the essence of a Stock Corporation. This business form originated in England in the 16th century and is one of the critical elements in the evolution of modern business as we know it today.

Individuals can pool their resources in a Stock Corporation to carry on huge business ventures that could carry considerable risk of failure, endangering the individuals' entire fortune should they attempt the venture as an individual or partnership. Several individuals can pool their resources in a Stock Corporation and engage in a venture which they could not afford as individuals.

Stock Corporations are essential to our economic way of life because limited liability is the one feature which is essential to individuals taking the risks that are necessary for a free-enterprise economy to function.

It is very obvious that if individuals are going to invest in huge ventures which are the essence of a modern economy they must have some protection from the unlimited liability that the venture could expose them to, especially when that individual is in business with other persons they cannot control.

C-Corporations

The traditional Stock Corporation is generally referred to as a c-corporation (c-corp). It must pay Kentucky Corporate Income Tax on its profit and Kentucky Corporate License Tax on the "capital employed" in the business.

In general, stocks in c-corps are traded between owners with no restrictions.

Double Taxation

Since the corporation and the stockholder both pay taxes on the earnings of the business, these earnings are "double taxed." Many people believe that "double taxation," as it applies to corporate income, is wrong. The fact is that we pay taxes on the same money many times. We earn money and pay income tax; we build a house with that money and pay sales tax on the building materials; then each year we pay property tax on the house. When we die, the house could be taxed again as an estate. That is quadruple taxation. The same is true of a motor vehicle we own. Double or even triple taxation is not uncommon.

Other Types of Limited Liability Business Organizations

More recently, several new business forms have become available. These include small business corporations (commonly called Subchapter S Corporations or s-corps), Limited Partnerships (LPs), Limited Liability Partnerships (LLPs), Limited Liability Companies (LLCs). These newer forms of business operations provide owners with the legal protection from

liability of the traditional corporation while at the same time eliminating double taxation by having their income taxed only at the Individual Income Tax level.

Subchapter S Corporations

Over time, significant interest developed in business forms which protect the owners from the potential liabilities of the business venture and at the same time reduce the tax burden caused by “double taxation.” Governments have been very sensitive to this concern, especially for small, family-owned businesses. These governments have allowed corporations to elect to have their income taxed as individual income to their owners. This election is permitted by Title 26, Subtitle A, Chapter 1, Subchapter S, of the U.S. Internal Revenue Code and therefore these corporations are known as subchapter s corporations (s-corps).

Primarily intended for small businesses with few owners, an s-corp is a regular stock corporation. The s-corp may transfer the profit to its owners or leave the money in the s-corp to be used as operating capital or to be taken out at some later date. An s-corp can have no more than 75 stockholders. Stock can only be owned by an individual, an estate or certain trusts.

Kentucky has allowed this same election for income tax purposes. The s-corps must pay the Kentucky Corporate License Tax but not the Kentucky Corporate Income Tax. The profits (or losses) of the corporation are credited to the owners based on their ownership of the corporation and the owners pay Individual Income Tax on their distributive share.

Limited Liability Partnership

One of the dangers of being a partner in a General Partnership is that if one partner is negligent (medical malpractice, legal misfeasance, etc.) all partners are liable. The Limited Liability Partnership (LLP) eliminates this problem. In this business form, the partner is responsible for the debts of the partnership but not for debts arising out of the negligence or misconduct of another partner. Except for the limited liability provision, LLPs are considered to be GPs.

This form of business organization must be registered with the Secretary of State and was created for professional partnerships such as doctors, lawyers, accountants, etc., which are in the business of selling the partners’ intellectual labor. The obvious intent is to protect the partners from the irresponsible acts of other partners.

Limited Liability Company

Another form of business organization authorized in Kentucky is a Limited Liability Company (LLC). An LLC is an unincorporated business organization and can be a single member or multi-member LLC. There is little difference between the two. Both must file articles of organization with the Secretary of State.

A member can be an individual, partnership, corporation, trust, estate or another LLC. The members and managers are not personally responsible for the debts of the LLC. An LLC is taxed as a partnership unless it elects to be taxed as a corporation. Even if it elects to be taxed as a corporation, an LLC does not pay Corporate License Tax. The advantage of an LLC over an LLP is total limited liability, not the partial limited liability of an LLP. An LLC has become the preferred vehicle to use to legally avoid paying business taxes in Kentucky.

Limited Partnership

Another type of business organization authorized in Kentucky which can limit a partial owner's liability is the Limited Partnership (LP). An LP is an association of two or more "persons" with one or more limited partners and one or more general partners. Limited partners are not personally responsible for the debts of the LP unless they participate in the management of the partnership. General partners are responsible for managing the business and are personally responsible for the debts of the partnership.

An LP is formed by filing a Certificate of Limited Partnership with the Secretary of State. LPs do not pay income or license tax at the entity level. The partners are taxed on their distributive share; an individual partner is taxed as an individual, a corporate partner is taxed as a corporation but pays no Corporate License Tax.

Tax Avoidance Vehicles

The LLP, LLC, LP and s-corp are four different legal business entities which can be used to reduce or eliminate tax liability in Kentucky. They are being used at an alarmingly increasing rate. Graph 6 portrays the dramatic increase in the number of LLPs, LLCs, and LPs registered in Kentucky each year compared to corporations (c-corps and s-corps).

LLCs

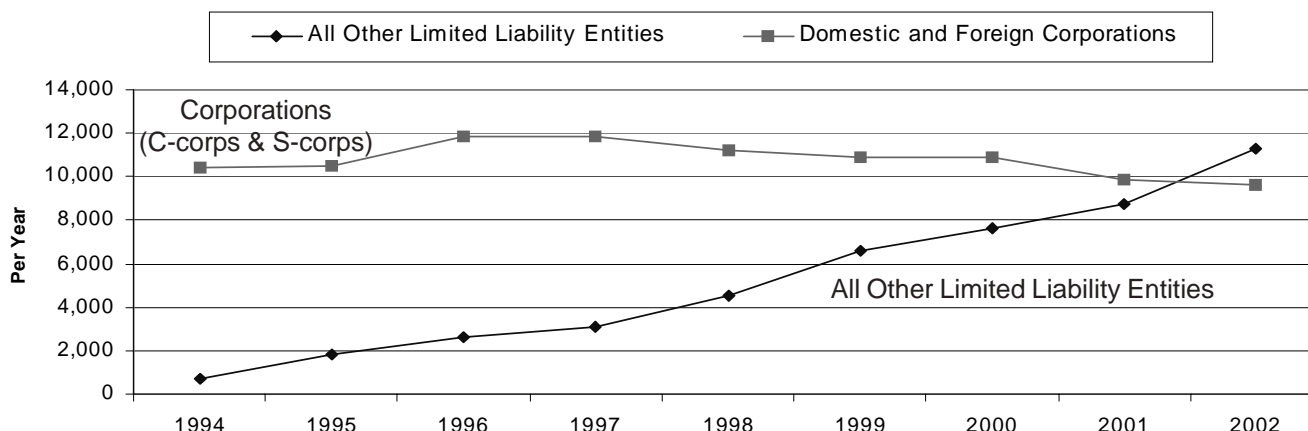
In 1994 the legislature authorized the LLC form of business organization in Kentucky and created the largest loophole in the history of our tax code. It is now the preferred vehicle used to avoid taxes in Kentucky because it enjoys complete limited liability and companies organized this way pay no Kentucky Corporate License Tax. As of January 2003, there were 33,246 active business entities in Kentucky registered as LLCs (29,781 domestic and 3,465 foreign).

Figures 2 and 2A portray two ways a business can organize to legally avoid paying corporate taxes in Kentucky using an LLC⁶. Figure 2 describes how the entities can be organized. Figure 2A displays hypothetical examples that result in no Kentucky tax liability.

⁶Organizing as an LLP or LP would provide the same tax avoiding opportunity.

GRAPH 6

Yearly Start-Ups of Corporations (Domestic and Foreign) Compared to Start-Ups of All Other Limited Liability Entities



Source: Office of Kentucky Secretary of State

It is important to realize that the partners in an LLC can be corporations. A corporation, even if it is wholly owned by another parent corporation, can form an LLC. Thus a parent corporation can own and totally control an LLC. Being an LLC, the business entity pays no Corporate License Tax or Corporate Income Tax. The owners of the LLC would be liable for income tax on the profits, but since the parent corporation can control the profit of the partnership by controlling the price it pays for goods or services received from the parent corporation, there will, in all likelihood be no profit on which to pay tax. Even if there is a profit, the LLC can apportion that profit to Kentucky based on sales only. If its sales in Kentucky are 1.5 percent of its total sales, a typical percent for a national company, Kentucky gets credit for very little of the profit.

There are several ways to avoid paying any taxes in any state. One scenario is to take advantage of the fact that Delaware has no tax on income derived from intellectual property. Suppose a parent corporation incorporates in Delaware and has all its operating facilities in subsidiaries, other wholly owned corporations or partnerships. The parent corporation owns only its name and its other intellectual property. It leases these intellectual assets to its subsidiaries for an amount which just happens to be equal to the combined profits of all its subsidiaries. It pays no taxes in Delaware, and none of the subsidiaries has taxable profit in any state.

Now suppose the parent corporation's subsidiaries establish an LLC in Kentucky to conduct its business in the Commonwealth. The LLC pays no Corporate License Tax, and, since all the profit has been exported to Delaware, it creates no income tax liability in Kentucky. This is a simplistic analogy of the real world. Real world business relationships and transactions between closely related companies are much more complex but they can result in the same outcome.

Figure 2

Two Methods to Reduce Kentucky Corporate Taxes

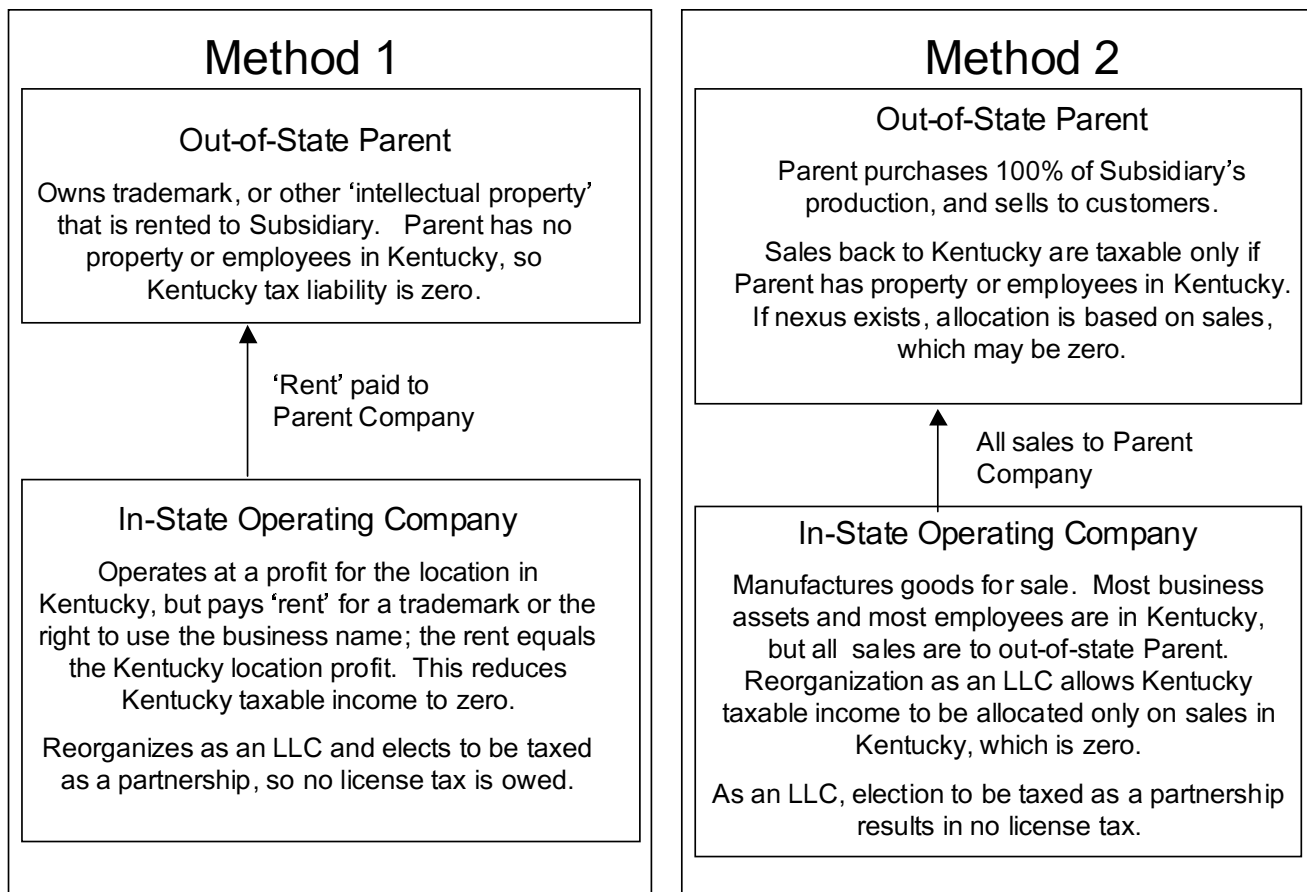
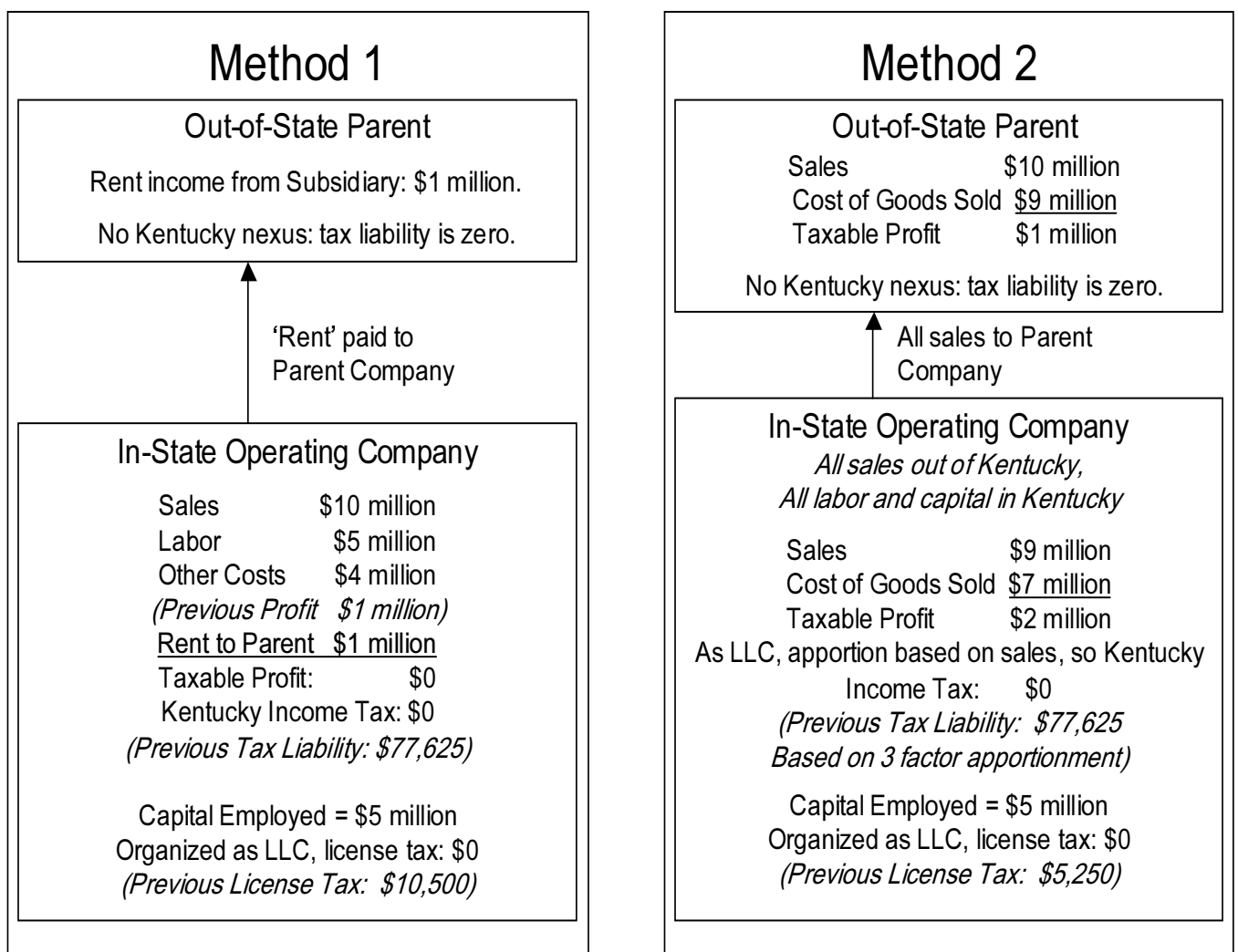


Figure 2A

Example of Two Methods to Reduce Kentucky Corporate Taxes



Kentucky and most other states have laws requiring fair valuation of business dealings between closely related companies. As a practical matter, a state cannot audit and evaluate the many transactions between large closely related companies. Additionally, it is difficult to prove that transactions are not “at arm’s length” and even more difficult to prove what the business’s income would be if they had been.

Using LLCs to avoid taxes is widespread in Kentucky. Table 2 is a partial list of LLCs registered in Kentucky, many of which would appear to be subsidiaries or affiliates of major corporations.

LPs

The Limited Partnership (LP) is also a very convenient vehicle to use to avoid taxes and to enjoy the benefits of limited liability. An LP can be the vehicle for business entities to organize a specific business venture to limit legal exposure for most partners and allow for the opportunity to manipulate income between affiliates. As of January 2003, there are 4,868 businesses registered in Kentucky as LPs (3,037 domestic and 1,831 foreign). Table 3 is a partial list of LPs registered in Kentucky, many which appear to be subsidiaries or affiliates of major corporations.

LLPs

LLPs can be used to avoid business taxes but it would appear that many of the LLPs in Kentucky are professional partnerships which is what this business organization was designed to accommodate.

TABLE 2

Notable Limited Liability Companies (LLCs) In Kentucky

Ahlstrom Engine Filtration LLC
Aisin Automotive Castings LLC
Catlettsburg Refining LLC
Marathon Ashland Petroleum LLC
Marathon Ashland Pipe Line LLC
Speedway Superamerica LLC
Food Lion LLC
K K I LLC dba Six Flags
Phar Mor Inc LLC
Verizon Wireless Services, LLC
Cingular Wireless, LLC
Cagle's-Keystone Foods LLC
Turfway Park, LLC
Alliance Coal LLC
Newport On The Levee LLC
Eagle Industries LLC
Land O Sun Dairies LLC
G E Lighting LLC
Conseco Services LLC
Webster County Coal LLC
Newcomb Oil Co LLC
Cinergy Power Generation Services, LLC
Fisher Scientific Co LLC
Louisville Forge And Gear Works, LLC
Morton Custom Plastics, LLC
Audubon Metals, LLC
Johnson Controls Interiors, L.L.C.
Amak Brake, L.L.C.
Owensboro Grain Edible Oils, LLC
Lynx Services From Ppg Industries, LLC
Anson Stamping Company, LLC
The Budd Tallent Company LLC
I.T. Springwire, LLC
Holiday Mansion International Of Kentucky, LLC
Joseph-Beth Booksellers, LLC
Yamamoto Fb Engineering LLC
Superior Coatings, LLC
Span Tech LLC
Synergy Tool & Gauge LLC
Unified Food Service Purchasing Coop LLC
Martin Industries, LLC
Rj Industries LLC

TABLE 3

Notable Limited Partnerships (LPs) In Kentucky

Kroger Limited Ptrshp I
Kroger Limited Ptrshp II
Wal-Mart Stores East, Limited Partnership
Wal-Mart Stores East I, Limited Partnership
Meijer Stores Limited
Dollar General Partners
Dell Marketing LP
Dell Catalog Sales LP
Garden Ridge LP
Gap Kentucky LP
River Center Hotel Ltd
Amerigas Propane LP
Westvaco Kentucky L
Outback Indianapolis II LP # 1
Tyco Adhesives LP
Zeon Chemicals LP
Indiana Gaming Co LP
Steel Technologies LP
Astra Pharmaceuticals LP
Best Buy Stores LP
Link-Belt Construction Equipment Company, Ltd
Steinkamp Molding LP
Eckart American LP
North American Stainless LP
Carlisle Equipment Group LP
Vulcan Construction Materials LP
Air Products Polymers LP
Sprint Communications Company LP
Sprint Spectrum LP dba Sprint PCS
Banana Republic East LP
Metromedia Steakhouses Company LP
Crossroads Memphis LP dba Hampton Inn Louisville
Old Navy East LP
Ferrellgas, Limited Partnership
Autozone Texas, Limited Partnership
Petro Stopping Centers LP
Sonic East, Limited Partnership
Chevron Phillips Chemical Company Limited Partnership

CORPORATIONS ARE VITAL TO KENTUCKY'S ECONOMY

The previous discussion should not be interpreted as an attack on Kentucky corporations⁷. No one should fail to understand what businesses mean to Kentucky, what they cost Kentucky and what they get from Kentucky. Most major national or international businesses operating in Kentucky operate one way or another as a c-corp because of the simple process of selling stock to transfer ownership which is an essential element of most major business enterprises. The actual entity operating in Kentucky may be a partnership of some sort but its ultimate owner is most likely a c-corp.

Corporations provide almost all of the jobs in Kentucky directly or indirectly. They are absolutely vital to our economic well being. Our state-imposed cost of doing business (taxes and regulation) must stay competitive with our sister states, especially our four primary competitors – Tennessee, Illinois, Indiana, and Ohio. It would be a grave mistake for the people or the leaders of Kentucky to try to make the business community pay an unfair portion of the cost of state government.

Competitiveness

Kentucky is very competitive. The previously referred to *Assessment* includes the Barents Group's analysis of Kentucky's overall effective tax rates for businesses and ranks Kentucky 10th lowest among 14 competitor states in our region (Table 4).

In a similar study in 1995, the Barents Group found that our economic development incentives make us tied with Alabama for the lowest effective rate when these incentives are used.

The United States Census Bureau reports that we are substantially below all four of our primary competitors when corporate income and license taxes are measured as a percent of total taxes collected.

This report does not discuss property taxes as an element of business taxes; however, when this tax is considered, Kentucky is significantly below our competitor states.

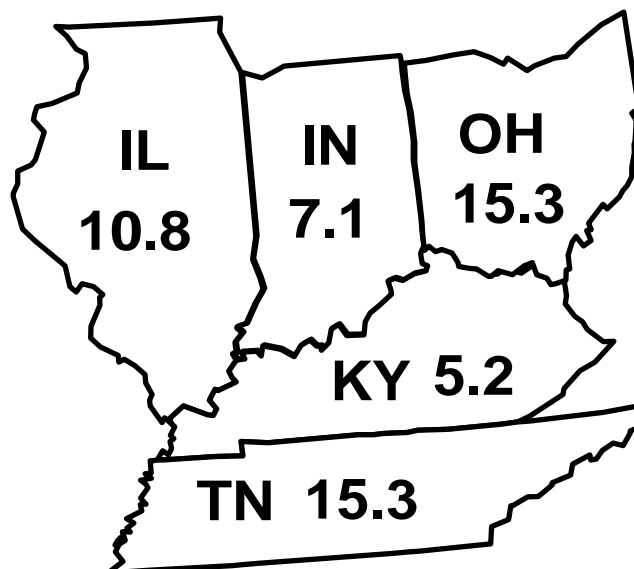
⁷When the term corporation is used in this report it generally refers to a corporation and all its subsidiaries of any nature.

Table 4
Effective Tax Rates for Businesses in Kentucky and 14 Competitor States

<u>Rank</u>	<u>State</u>	<u>Effective Rate</u>
1	Mississippi	15.34%
2	Ohio	14.44%
3	Missouri	13.73%
4	Michigan	13.11%
5	Indiana	12.97%
6	Tennessee	12.34%
7	Arkansas	11.06%
8	North Carolina	10.89%
9	Georgia	10.69%
10	Kentucky	10.62%
11	South Carolina	10.35%
12	Virginia	10.03%
13	Illinois	9.87%
14	West Virginia	9.50%
15	Alabama	8.68%
	Regional Average	11.57%

Source: Barents Group LLC, Comparative Analysis of Kentucky's Tax Structure, December 1999

FIGURE 3
Corporate Income & License Taxes
As a Percent of Total Tax Collections
January - June 2002



Regional Average (excluding KY) 12.1

Source: U.S. Census Bureau

BUSINESSES SHOULD PAY FAIR SHARE

We must stay competitive but we should also expect Kentucky's business citizens to pay their fair share. "Their fair share" is a nebulous term and its definition will vary from person to person but it is incumbent on Kentucky to decide what is the "fair share" of the cost of state government that should be borne directly by our business citizens.

In FY 89, before KERA was enacted, corporate support for state government was 11.6 percent of the General Fund. In FY 02 it was 5.0 percent of the General Fund. That is a dramatic change! What is corporate Kentucky's fair share? 5.0 percent or 11.6 percent?

The KERA Tax Increases

A good place to start to examine that question is 1990 when Kentuckians decided to improve education and raised taxes on themselves to do it. At that time, corporate support for our General Fund was \$355 million a year, 10.0 percent of the General Fund. To pay for improved education, the Individual Income Tax was increased 22.0 percent (several changes); the Sales and Use Tax was increased 20.0 percent (from 5 percent to 6 percent); and the Corporate Income Tax was increased 13.8 percent (the top rate increased from 7.25 percent to 8.25 percent). One could assume that corporate Kentucky had agreed to pay 13.8 percent more to get a well-educated workforce, an increase which would be sustained as the economy of Kentucky grew.

Since FY 90 the revenue from the Individual Income Tax has increased from \$1.21 billion (34.0 percent of the General Fund) to \$2.70 billion (41.2 percent of the General Fund) in FY 02, an increase of 123 percent. Sales and Use Tax revenue has increased from \$1.09 billion (30.5 percent of the General Fund) to \$2.30 billion (35.1 percent of the General Fund), an increase of 112 percent. Property tax revenue has increased from \$303 million (8.5 percent of the General Fund) to \$433 million (6.6 percent of the General Fund), an increase of 43 percent. Other revenue sources such as the coal severance tax, cigarette taxes and the lottery brought in \$607 million in FY 90 (17.0 percent of the General Fund) and \$800 million in FY 02 (12.2 percent of the General Fund), an increase of 31 percent.

In contrast, total corporate support for state government decreased from \$355 million (10.0 percent of the General Fund) to \$325 million (5.0 percent of the General Fund), a decrease of 8.4 percent! Corporate Kentucky is not doing its part to support education improvement, an effort led by some of the major corporate leaders of the Commonwealth in 1990.

It is hard to understand how anyone could view the current relative tax burden as fair compared to the relative tax burden which existed twelve years ago. The Kentucky General Assembly certainly did not make a conscious decision to change our tax laws to achieve this redistribution of the tax burden in Kentucky. The General Assembly changed the law, but it did not anticipate the consequences.

The Growth of the Five Major Revenue Streams

Graph 7 portrays the growth of the five General Fund revenue streams discussed in this report from FY 90 to FY 02 relative to the revenue which each stream produced in FY 90. This is a graphic display of the redistribution of the tax burden which has occurred since the General Assembly made a significant adjustment to the tax code in 1990.

The graph is indexed to 1990. If each of the five revenue streams had grown equally, the five lines would have stayed together as they are in 1990 and risen as revenue increased over the years. The fact that they diverge shows the redistribution of the tax burden since 1990. The Individual Income Tax and the Sales and Use Tax have grown substantially. The other three sources have been stagnant; the Property Tax because of House Bill 44; other taxes because the lottery, cigarette taxes and coal severance tax are flat; and corporate taxes because we have created the loopholes for tax avoidance that corporations are obligated to use.

Referring again to Graph 4, on page 33, the decline in corporate support for state government mirrors the increase in the use of LLCs, LLPs, and LPs. There can be little doubt that the decline is permanent.

The Consensus Forecasting Group has projected the decline in corporate support for state government to stop and level off. This may not be a valid assumption because the rate of registration of new LLCs, LLPs, and LPs has not declined. If the loophole to eliminate taxes exists, we should expect more and more businesses to use it.

Corporations Pay Other Ways?

Some will argue that the owners of these corporations pay their fair share through individual income taxes. But what about the stockholders who aren't subject to Kentucky Individual Income Tax (nonresidents) but who own stock in corporations that earn income for them in Kentucky as a result of services provided by Kentucky State Government? Shouldn't they pay their fair share of the cost of those services?

Recently there have been some arguments advanced that the proliferation of pass-through entities like s-corps, LLCs, LLPs, and LPs has merely shifted state revenue away from the Corporate Income Tax and to the Individual Income Tax. This argument claims that the state continues to receive business' "fair" share, but individuals, not business, are getting credit for the revenue. This line of reasoning does not consider the Corporate License Tax avoidance, which is a 100 percent loss of revenue to state government if the pass-through entity is a LLC, LLP, or LP. To the extent the corporations which were paying Corporate Income Tax in 1990 and are now LLCs or some other form of pass-through business are owned by individuals, this argument might have some validity. It is probable that few, if any, of the businesses in Table 2 or Table 3 are owned by individuals.

Unfortunately, Kentucky Individual Income Tax returns do not require filers to report pass-through income earned by s-corps, LLCs and other limited liability entities separately, therefore we cannot verify this claim. No doubt some of this occurs, and the growth of these entities has certainly helped to boost Individual Income Tax revenues some. However, this does not appear to explain the poor performance of the Corporate Income Tax. To demonstrate this, one should consider that the federal government, just like the state, recognizes these pass-through entities for their tax purposes. Therefore, if Corporate Income Tax revenue is merely being shifted to the Individual Income Tax, then we should expect to see the same poor performance in federal corporation income tax revenues.

In fact, federal corporation income tax revenue in FY 01 was 69 percent higher than its level in FY 90. Federal corporation income tax revenue peaked in FY 00 at 214 percent of its FY 90 level before falling due to the recession. Here in Kentucky, Corporate Income Tax revenue in FY 01 was just 4 percent greater than its level in FY 90, and peaked all the way back in FY 95 at just 122 percent of its FY 90 level. Considering that our top marginal rate was raised a full percentage point in FY 91, this indicates that corporations are able to take advantage of certain tax-avoidance strategies at the state level that are not available at the federal level. Or, put another way, this isn't money that was just shifted into the Individual Income Tax.

A major proportion of pass-through income is passed to other businesses, not individuals. The ultimate beneficiaries of these pass-throughs are the stockholders of these large corporations.

In all likelihood most of the stockholders of large national and international corporations will pay no Kentucky tax on the profit they make because they are not Kentucky residents. They receive profits because the corporations do business in Kentucky and use the services of Kentucky such as education, infrastructure, public protection, business regulation and other similar services. If the corporation pays no taxes, these out-of-state owners would benefit from services paid for by Kentuckians and would have paid for none of the costs. That's the reason all states have some taxes paid by corporations which are not paid by individuals.

Corporations can retain some (or all) of their earnings to reinvest and increase the wealth of their stockholders without the stockholder receiving a dividend or having to pay any tax on their gain unless and until they actually convert that gain to cash by selling their stock (or liquidating the corporation).

Since corporations benefit from Kentucky state government, and stockholders not residents of Kentucky and not subject to any Kentucky taxes thereby benefit, it is the belief of the Patton Administration that all corporations should support state government.

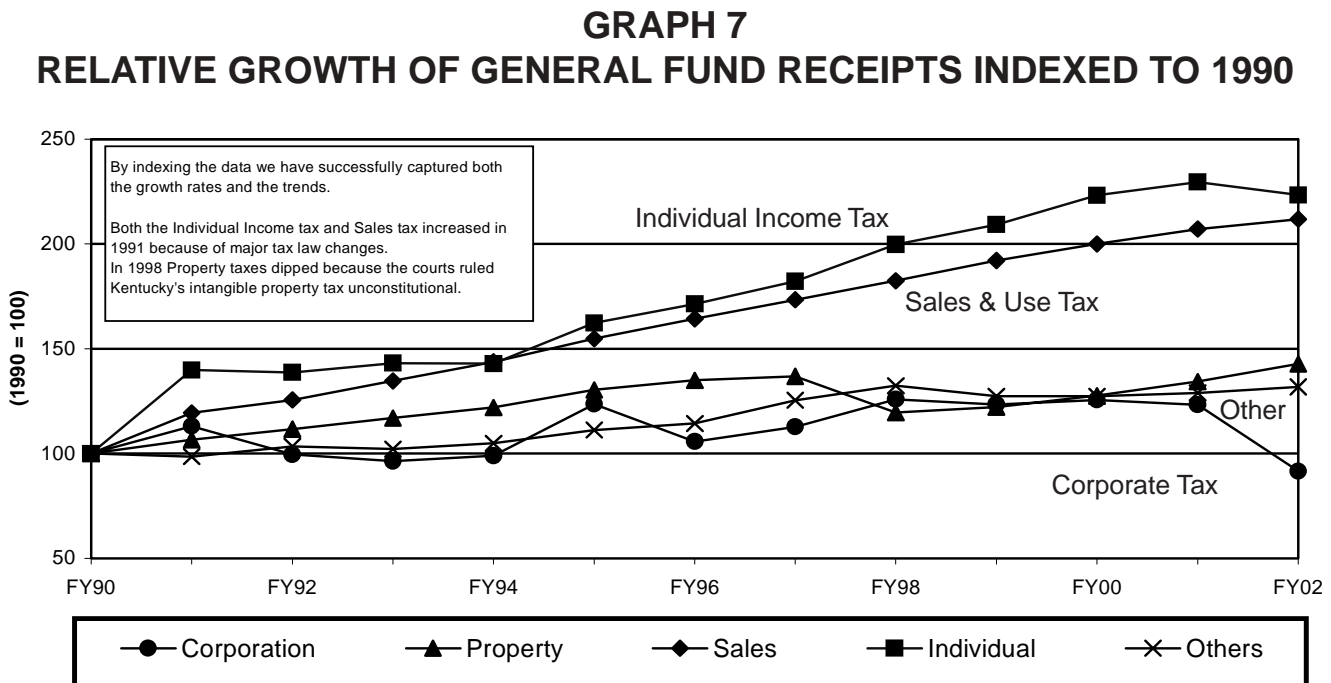
Since Kentuckians constitute only about 1.5 percent of our national population, Kentucky should assume that the national corporations which contribute the most to Kentucky's economy are owned more than 98 percent by nonresidents.

Corporate Support for State Government

We in Kentucky must answer a fundamental question; what portion of the cost of state government should be borne by our corporate citizens as their fair share of the cost of state government services used by the corporate community as they carry on their business activities in Kentucky? Before that question can be answered, Kentucky is going to have to clarify how it wants to tax business activity in the Commonwealth.

The fact is that current corporate policy in the United States is to minimize, using perfectly legal business practices, the taxes they pay to support state governments. This is the primary reason that corporate support for government in Kentucky has dramatically declined. The practice of exporting profit to some place where it is not taxed is a major phenomenon in the United States.

No one should criticize these corporations. It is entirely appropriate that any taxpayer use every legal vehicle to minimize their tax payments. Management which does not use



every legal means to reduce corporate expenses, including taxes, would not be maximizing the corporation's return to its stockholders. The challenge is for governments to devise tax codes which make it mandatory that all taxpayers, individual and business, pay their fair share of the cost of government services.

Any tax policy should observe one basic rule. Businesses engaged in the same business and competing in the same market should be taxed the same. No rational economic policy would support taxing the same business activity differently just because of its organizational structure.

Should Businesses Pay Taxes?

This subject could be boiled down to a fundamental question. Should businesses pay taxes to help support government? One could argue that people are the ultimate beneficiaries of government and should pay for government. One could argue that since people own businesses and eventually pay taxes when they receive the earnings of the companies they own, the companies should not be taxed.

One could also take the position that businesses create jobs and people benefit from jobs and therefore people should pay for the government that is necessary for businesses to exist and prosper.

If this were the philosophy that a society adopted, and if all the owners of businesses lived in one state and all the employees live in the other 49 states then the owners would earn their income and have no responsibility to pay for the education of the workers. The owners would not have to pay for the infrastructure their businesses use. The owners would not have to pay for the protection of their property from criminals who would steal it.

Kentuckians should not bear the complete burden of the cost of state services being used by businesses owned by out-of-state individuals who pay nothing for those services.

The Commonwealth has taken the position that businesses must pay taxes but then our laws allow certain businesses, depending on how they are organized, ways to avoid those taxes. Kentucky needs to decide a fundamental question; are we going to require businesses to pay taxes to support government? The fact is that we have already made that decision. We just don't have a tax code which ensures that it happens.

KENTUCKY'S CORPORATE TAX SYSTEM IS FLAWED

The fact of the matter is that the loopholes we have created in our laws to tax corporations have rendered the Corporate Income Tax and the Corporate License Tax invalid instruments to use to determine a corporation's fair share of the cost of state government.

This is a problem not just in Kentucky but throughout the country. Corporations have become very adept at using the vehicles states have created to establish sophisticated networks of wholly owned subsidiaries to manipulate profit to show it to be earned in states which have no corporate income tax or in foreign countries.

This is truly a case of "build it and they will come." In a very few years, the only corporations that will be paying corporate income tax in Kentucky will be those small corporations which are not sophisticated enough to establish these networks to export all their taxable income outside of the state. Kentucky should do one or the other. We should tax all businesses that enjoy limited liability or tax none of them.

Corporate Taxes Based on Income are Very Volatile

Even if corporations weren't moving profits away from states which tax corporate profits, the Corporate Income Tax is not a good gauge of a corporation's obligation to support state government because this source is too volatile. The volatility of corporate income tax revenue is caused by the direct relationship of corporate profits to the business cycle. It is not at all unusual for major corporations to have earnings which vary widely from large profits to huge losses. With laws allowing for loss carry-forwards being a part of our tax code, the norm is for corporations to pay corporate income taxes for some time and then have losses that are carried forward into future years. Therefore they pay no corporate income tax for several years. An even more serious problem is the two-year carry-back provision because it often triggers large refunds that must be paid out of current-year revenue.

If stability of the revenue stream is of any concern, there is no doubt that Corporate Income Tax revenue is by far the most volatile of all our revenue streams. And it certainly hasn't grown! This revenue stream could be doubled and not put Kentucky at a disadvantage relative to our competing states.

So long as corporate support for state government is determined by its year-to-year profit, this source of support of state government will be very volatile and will continue to decline.

Acknowledging that the need for state government services does not go down with declines in the business cycle and corporations do not cease using state services with declines in the business cycle, a substitute for the Corporate Income Tax to establish our corporate community's fair share of support for state government services is in order.

Achieving More Stable Support

A corporation's obligation to support state government should be relatively constant and should be reflective of its use of state government services.

Critics will claim that a corporation should not be required to pay taxes when it is not profitable but they are ignoring the fact that we all pay sales tax and property tax regardless of how much money we may make or lose in a given year. Mineral extracting companies pay severance tax regardless of their profitability.

Many major corporations continue to pay dividends to their stockholders in years they are not profitable; see Graph 8. Why? Their owners need income to live on every year. States need revenue to provide services every year also. What is necessary for owners is also necessary for state governments.

The proposal in this report is a fundamental change which must be made if the way Kentucky taxes our corporate citizens is going to be adjusted to address the five criteria established earlier in this report. It is obvious that the failure of corporate tax revenue to grow as inflation and the needs of education grow and as revenue from the Individual Income Tax and the Sales and Use Tax grows is the major reason Kentucky's current revenue is inadequate.

Many other states are concerned about this problem. Michigan and New Jersey have moved away from the Corporate Income Tax as the primary vehicle for businesses to support state government. Just last August, the Southern Governors Association asked the National Governors Association to analyze and report on the status of the corporate income tax as a source of support for state governments.

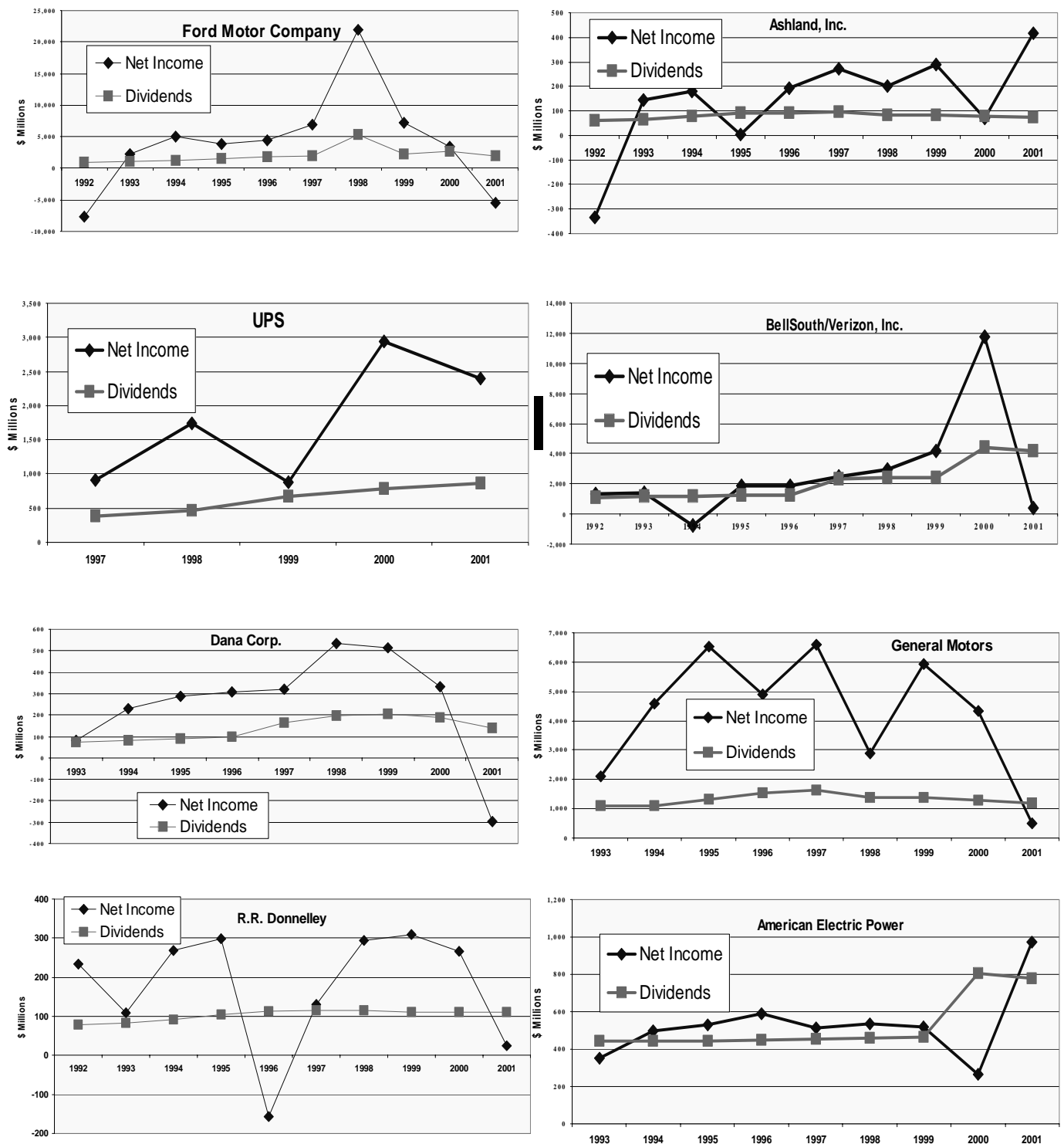
How Much Should Businesses Pay?

A fundamental question is: how much (as a percentage) of the cost of state government should be paid by the business enterprises which have been granted limited liability status by state government and which have the ability to use state services to earn income for non-Kentucky residents?

Sincere people could disagree on that question, but the people of Kentucky, acting through their legislature, have answered it; 10 percent, as articulated in the Kentucky Equity Tax Act (KETA) of the 1985 legislature.⁸ This decision may have been influenced by the fact that corporate profits have averaged about 10 percent of total national income over the past 20 years. Until the past few years we, in general, lived by that decision.

⁸Source: Revenue Estimates for the Biennium: July 1, 1990 - June 30, 1992, Finance and Administration Cabinet, Commonwealth of Kentucky.

GRAPH 8 **Net Income and Dividends Paid by Large** **Corporations Operating in Kentucky**



Source: Company Financial Reports

In FY 1990, the business community led the charge to improve education in Kentucky and business interests promised to pay their fair share. As we look at the actual results twelve years later we find that the anticipated increased support from the corporate community has not materialized. Individuals have picked up the costs that corporations had been expected to pay.

The administration is proposing a measure to completely change the way we tax the business community to achieve fairness, stability and growth, and to restore corporate support for state government to the 1990 level. This may be the most complicated tax issue to face Kentucky. It is also the most important subject in the debate to reform the Kentucky Tax Code. It will be very difficult for the average person to understand the details of this issue but it is certain that the tax lawyers and accountants of the business community understand it. And they will use the system as it is to minimize the taxes they pay, as they should. As previously stated, to not reduce the expenses of a business when legal ways to do it are readily available is not looking out for the best interests of the stockholders. Management's first obligation is to its stockholders.

A NEW SYSTEM

A new system of taxing businesses which allows them to compete on a level playing field and provide substantial and sustained support for state government services commensurate with the value of services received must be developed. We certainly don't have that now. In 2000, 37,207 corporations filed Corporate Income Tax returns. Two corporations paid 10 percent of the Corporate Income taxes. Corporate License tax returns were filed by 32,115 corporations. Eleven of them paid 10 percent of the Corporate License Tax. This could not possibly be fair.

The Patton Administration strongly supports a proposal to bring fairness and stability to business support for state government. Our proposal is to repeal the Corporate Income Tax and replace it with a Business Activity Tax (BAT) and change the name of the Corporate License Tax to the Business License Tax (BLT). The BAT and the BLT would apply to all businesses operating in Kentucky which are operating with limited liability, excepting professional LLPs or LLCs (doctors, lawyers, accountants, etc.), banks and insurance companies.

There should be no change in the way we tax insurance companies and financial institutions. A review of taxes being paid by these kinds of businesses indicate they are paying their fair share of the cost of state government.

Public service companies currently pay the Corporate Income Tax but are not subject to the Corporate License Tax. For those companies the proposal would replace the Corporate Income Tax with the BAT. Public service companies, except communications companies, would continue to be exempt from the license tax. Communications companies would become subject to the BLT under the communications tax reform proposal.

This change would dramatically improve the stability of state revenue and would provide a revenue stream which would grow directly with the state's economy and be only slightly impacted by the business cycle.

Business Activity Tax

The BAT would have two elements; a tax on the labor employed in Kentucky (payroll) and a tax on the business's gross receipts from sales in Kentucky.

The BAT on payroll will be applied to all labor performed in Kentucky, even by nonresidents who do not pay the Kentucky Individual Income Tax due to reciprocity agreements. The BAT on gross receipts would apply to all gross receipts from sales in Kentucky, even those by out-of-state businesses.

Several states have some form of a gross receipts taxes. Among them are:

<u>State</u>	<u>Rate</u>
Washington	0.138 percent to 3.3 percent
Delaware	0.096 percent to 1.92 percent
Michigan	1.9 percent
New Jersey	0.125 percent to 0.4 percent
Nevada (proposed)	0.25 percent

The Michigan Single Business Tax starts with payroll and adds and subtracts several items such as dividends, interest, depreciation, employee benefits, royalties, and profit, and then applies a 1.9 percent tax rate to the final total.

Preventing Double Taxation

To prevent double taxation of owners that the state has decided to exempt from double taxation, individual owners of LPs, LLPs, LLCs and s-corps subject to the tax will be granted a tax credit on their Kentucky Individual Income Tax equal to their proportional share of the BAT paid by their company. This credit will be on their total tax owed and not limited to the taxes on income earned in the business. This should mute one of the most widely heard objections to this concept which is that the taxes which are not being paid by corporations are now being paid by individuals through the Individual Income Tax.

Some companies do pass-through their profit to their owners who then pay taxes to the state. That was true in 1990 and it is true today. The new system should be revenue neutral to these owners.

Should Businesses Pay Tax in Years They Make No Profit?

Another objection that has been lodged is that businesses shouldn't have to pay taxes when they don't make a profit. That argument has already been addressed and is not really valid, especially when the corporation pays dividends with little relationship to year-to-year profits. Businesses are in business to make a profit over time. If they don't they won't survive. Over time, this tax will be fair to business. This tax should be viewed as the state's charge to the business for the state services the businesses use. They use these services whether they make a profit or not.

Approach Different Than New Jersey

This proposal is a complete replacement of the Corporate Income Tax by the BAT. New Jersey took a different approach. It left its Corporate Income Tax in place, eliminated several loopholes and requires the business to pay the higher tax, their equivalent Business Activity Tax or the "Alternative Business Assessment." In other words, it enacted its Business Activity Tax to put a floor, but no ceiling, on the taxes its corporations pay.

Business License Tax

Some companies paid Corporate License Tax in 1990 and are now using alternative business forms to avoid this tax. However, many businesses are still paying the Corporate License Tax. In fairness to them, everyone should pay it or it should be repealed.

A recent court decision would have the effect of extending the current corporate license tax to the capital of in-state corporations that hold a significant investment in subsidiary companies. The impact of this ruling would be to tax multiple times some capital employed within Kentucky. This would result in all corporations being treated fairly, but in-state corporations would pay tax on capital that was previously excluded. Accordingly, part of Governor Patton's proposal is to extend the exclusion that was previously granted only to in-state corporations (and was thus declared unconstitutional) to all corporations wherever located. The goal of making Kentucky more attractive to businesses, and particularly corporate headquarters, is significantly enhanced by this change.

The name of the Corporate License Tax will be changed to a Business License Tax (BLT) and special exceptions added to the tax code over the years will be repealed. Professional LLPs and LLCs which provide professional services to a third party would continue to be exempt, as would investments in financial institutions subject to the bank Franchise Tax and public service companies (except communications companies, which are discussed elsewhere in this report).

The Business License Tax could be viewed as the price a business pays to receive the protection of limited liability, a protection granted by government. A business owner could get this kind of protection from an insurance company. They would pay for the protection. Limited liability has value to a business owner. The government which grants that value should receive some of it.

Rates

The new business taxing system would apply to three elements of a business activity in Kentucky; its sales, labor and capital employed.

Our objective is to establish the revenue from the business community subject to this tax at the same 10 percent of General Fund revenue which existed in FY 90, the year that the business community led the effort to convince the people and the policy makers of Kentucky that we had to have better schools to produce a better-educated workforce.

That would be a net total of \$736 million in FY 04 after adjustments for economic development credits and deductions for pass-through credits on individual income Tax. This will net \$340 million more than is estimated by the Consensus Forecasting Group to be generated by corporate taxes in that fiscal year.

The rates needed to do that will be:

Sales: 0.13 percent of Kentucky sales, one dollar and thirty cents per one thousand dollars of sales, \$0.13/\$100 of sales.

Payroll: 0.60 percent of Kentucky payroll, six dollars and ten cents per one thousand dollars of payroll, \$0.60/\$100 of payroll.

Business License Tax: 0.41 percent of capital employed, four dollars and ten cents per one thousand dollars of capital employed, \$0.41/\$100 of capital employed.

(This would be a 95 percent increase in the present Corporate License Tax which is currently \$0.21/\$100.)

Each strand of revenue would be about one-third of the total revenue.

Economic Development Analysis of Effect on Businesses

For the purposes of analyzing the effect of this taxing system, the Governor asked the Cabinet for Economic Development to select at random several of its recent offers of tax incentives to companies considering Kentucky for a new business. Table 5 shows the effect of the new system on seven service businesses. Table 6 shows the effect on seven manufacturing businesses.

In nine of the fourteen examples, the estimated tax paid under the proposed new taxing method would be less than would be paid under the existing tax laws, and in most of those cases the tax would be substantially less.

A Dramatic But Vital Proposal

As dramatic as this proposal is, it would be the single most important action that could be taken to return fairness to our system of taxing business activity in the Commonwealth, provide a revenue stream adequate to meet our commitments, increase the stability of the state's revenue stream and provide the increased revenue that a growing society must have. This proposal may, in some instances, slightly decrease the current competitive advantage we have over our neighboring states (as demonstrated in the Barents reports and by actual calculations of the Cabinet for Economic Development) when we evaluate the entire cost of doing business in Kentucky to those same costs in these other states, but it will not put us at a competitive disadvantage. The only way to do that is to let education deteriorate.

TABLE 5
ECONOMIC DEVELOPMENT TAX COMPARISON
SERVICE COMPANY EXAMPLES
(Dollars)

		<u>Tax Liability Under Present Tax Structure</u>	<u>Tax Liability Under Proposed Structure</u>	<u>Present vs. Proposed Structure</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	7,929,775	0	47,579	47,579
Estimated KY Taxable Income	8,257,000	676,328	0	-676,328
Kentucky Capital Employed	<u>7,346,000</u>	<u>15,427</u>	<u>30,119</u>	<u>14,692</u>
Totals		<u>691,754</u>	<u>77,697</u>	<u>-614,057</u>
Kentucky Sales	9,457,531	0	12,295	12,295
Kentucky Payroll	1,402,692	0	8,416	8,416
Estimated KY Taxable Income	4,977,648	405,781	0	-405,781
Kentucky Capital Employed	<u>2,653,800</u>	<u>5,573</u>	<u>10,881</u>	<u>5,308</u>
Totals		<u>411,354</u>	<u>31,592</u>	<u>-379,762</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	707,250	0	4,244	4,244
Estimated KY Taxable Income	800,000	61,125	0	-61,125
Kentucky Capital Employed	<u>4,772,000</u>	<u>10,021</u>	<u>19,565</u>	<u>9,544</u>
Totals		<u>71,146</u>	<u>23,809</u>	<u>-47,338</u>
Kentucky Sales	125,426	0	163	163
Kentucky Payroll	5,433,360	0	32,600	32,600
Estimated KY Taxable Income	580,364	43,005	0	-43,005
Kentucky Capital Employed	<u>2,139,966</u>	<u>4,494</u>	<u>8,774</u>	<u>4,280</u>
Totals		<u>47,499</u>	<u>41,537</u>	<u>-5,962</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	5,684,880	0	34,109	34,109
Estimated KY Taxable Income	580,364	43,005	0	-43,005
Kentucky Capital Employed	<u>4,800,000</u>	<u>10,080</u>	<u>19,680</u>	<u>9,600</u>
Totals		<u>53,085</u>	<u>53,789</u>	<u>704</u>
Kentucky Sales	36,011,732	0	48,815	48,815
Kentucky Payroll	18,299,240	0	109,795	109,795
Estimated KY Taxable Income	3,987,000	324,053	0	-324,053
Kentucky Capital Employed	<u>34,000,000</u>	<u>71,400</u>	<u>139,400</u>	<u>68,000</u>
Totals		<u>395,453</u>	<u>296,011</u>	<u>-99,442</u>
Kentucky Sales	2,940,000	0	3,822	3,822
Kentucky Payroll	1,326,000	0	7,956	7,956
Estimated KY Taxable Income	162,000	9,590	0	-9,590
Kentucky Capital Employed	<u>1,762,112</u>	<u>3,700</u>	<u>7,225</u>	<u>3,524</u>
Totals		<u>13,290</u>	<u>19,003</u>	<u>5,712</u>

Notes: Tax rates expressed as cents per \$100: Sales 13, Payroll 60, and License 41.

Under Kentucky's existing tax incentive programs, Corporate Income Tax may be abated for up to ten years. If this concept is adopted, the Business Activity Tax would be substituted for Corporate Income Tax as a tax incentive with the exception of the tax on capital employed in Kentucky.

TABLE 6
ECONOMIC DEVELOPMENT TAX COMPARISON
MANUFACTURING COMPANY EXAMPLES
(Dollars)

		<u>Tax Liability Under Present Tax Structure</u>	<u>Tax Liability Under Proposed Structure</u>	<u>Present vs. Proposed Structure</u>
Kentucky Sales	2,700,000	0	3,510	3,510
Kentucky Payroll	2,850,400	0	17,102	17,102
Estimated KY Taxable Income	650,000	48,750	0	-48,750
Kentucky Capital Employed	<u>22,600,000</u>	<u>47,460</u>	<u>92,660</u>	<u>45,200</u>
Totals		<u>96,210</u>	<u>113,272</u>	<u>17,062</u>
Kentucky Sales	40,000,000	0	52,000	52,000
Kentucky Payroll	9,300,000	0	55,800	55,800
Estimated KY Taxable Income	2,400,000	193,125	0	-193,125
Kentucky Capital Employed	<u>40,000,000</u>	<u>84,000</u>	<u>164,000</u>	<u>80,000</u>
Totals		<u>277,125</u>	<u>271,800</u>	<u>-5,325</u>
Kentucky Sales	3,000,000	0	3,900	3,900
Kentucky Payroll	1,943,340	0	11,660	11,660
Estimated KY Taxable Income	1,500,000	118,875	0	-118,875
Kentucky Capital Employed	<u>2,226,517</u>	<u>4,676</u>	<u>9,129</u>	<u>4,453</u>
Totals		<u>123,551</u>	<u>24,689</u>	<u>-98,862</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	1,450,000	0	8,700	8,700
Estimated KY Taxable Income	3,500,000	283,875	0	-283,875
Kentucky Capital Employed	<u>5,850,000</u>	<u>12,285</u>	<u>23,985</u>	<u>11,700</u>
Totals		<u>296,160</u>	<u>32,685</u>	<u>-263,475</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	6,200,000	0	37,200	37,200
Estimated KY Taxable Income	6,200,000	506,625	0	-506,625
Kentucky Capital Employed	<u>53,000,000</u>	<u>111,300</u>	<u>217,300</u>	<u>106,000</u>
Totals		<u>617,925</u>	<u>254,500</u>	<u>-363,425</u>
Kentucky Sales	0	0	0	0
Kentucky Payroll	403,000	0	2,418	2,418
Estimated KY Taxable Income	39,600	1,730	0	-1,730
Kentucky Capital Employed	<u>225,000</u>	<u>473</u>	<u>923</u>	<u>450</u>
Totals		<u>2,203</u>	<u>3,341</u>	<u>1,138</u>
Kentucky Sales	1,000,000	0	1,300	1,300
Kentucky Payroll	3,744,000	0	22,464	22,464
Estimated KY Taxable Income	250,000	15,750	0	-15,750
Kentucky Capital Employed	<u>4,100,000</u>	<u>8,610</u>	<u>16,810</u>	<u>8,200</u>
Totals		<u>24,360</u>	<u>40,574</u>	<u>16,214</u>

Notes: Tax rates expressed as cents per \$100: Sales 13, Payroll 60 and License 41.
Under Kentucky's existing tax incentive programs, Corporate Income Tax may be abated for up to ten years. If this concept is adopted, the Business Activity Tax would be substituted for Corporate Income Tax as a tax incentive with the exception of the tax on capital employed in Kentucky.

PROVIDER TAX ON NURSING FACILITIES

The health care industry is a great beneficiary of Medicaid and many states tax medical service providers to help finance some of the states' share of the cost of Medicaid. In Kentucky this provider tax goes into the Medicaid Trust Fund. This is not a part of the General Fund. Currently the annual revenue paid directly into the Medicaid Trust Fund is approximately \$170 million, \$587 million less than the \$757 million General Fund share of the FY 04 Medicaid budget as proposed in House Bill 1.

Nursing Facility Services

One of the needs of the Medicaid program is to increase Medicaid funding to nursing facilities that care for Medicaid clients.

The only practical way to increase nursing facility funding to cover increased costs is to increase the state's available match. Since the federal government will pay 70 percent of any increased cost, this is the most likely place to get some of the new revenue needed for Medicaid. If the current 2 percent provider tax on nursing facility services is increased to 6 percent, \$47.9 million of new state match would be generated. This tax should be applied to intermediate care facilities for the mentally retarded (ICF/MR) as well. One-half of the new money (approximately \$80 million) would be used to cover the increased cost of nursing facility services. The remaining \$80 million will be available to cover some of the unmet needs in the rest of the Medicaid program.

Most nursing facilities will support this. Eighty-five percent of Kentucky's 26,000 nursing facility beds are Medicaid certified. Seventy-five percent of certified nursing facility beds are paid for by Medicaid. Many of the remaining 25 percent of certified beds that are occupied by private-pay patients will become Medicaid paid when the client's personal resources run out. For many private pay nursing facility clients, it is just a matter of time before they become Medicaid eligible.

STREAMLINED SALES AND USE TAX INITIATIVE

Remote sales (catalog, phone and internet sales) are a threat to the Sales and Use Tax revenue in every state because states have no practical way to collect taxes owed on remote sales if the vendor has no nexus in the state. The current estimate is that Kentucky lost \$107.3 million of this tax due in FY 02. Table 7 portrays the loss of revenue Kentucky will experience as estimated by Dr. William Fox, economist from the University of Tennessee.

TABLE 7

Net Revenue Loss Due to E-Commerce

<u>Year</u>	<u>\$ Million</u>
2001	84.0
2002	107.3
2003	137.2
2004	175.3
2005	224.0
2006	286.2

Source: Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," *State Tax Notes*, 15 Oct 2001, 203-214.

The National Governors Association and the National Council of State Legislatures have been working on a multi-state Streamlined Sales and Use Tax agreement that could result in states being able to recoup this lost source of revenue. The administration will be proposing a separate but related revenue-neutral change to allow Kentucky to participate in this multi-state program to collect the Sales and Use Tax owed on remote sales.

Kentucky has provided leadership to the committee of 39 states which has been working for 3 years to develop a system of collecting the Sales and Use Tax on remote sales which will pass the judicial test of not placing an unreasonable burden on interstate commerce. The result of the work of this group is that we and all states which wish to participate in the agreement must make the needed changes in the application of the Sales and Use taxes in their state to comply with the criteria agreed to by the committee. The states have agreed to adopt a uniform set of definitions of such items as food, candy, soft drinks, prescription drugs and prosthetic devices. We can elect whether to tax each defined group or not, but we cannot, for the most part, tax some subdivisions of a group and not tax other subdivisions of the group as we do today. This will require that we apply the Sales and Use Tax to some items we presently don't tax and exempt some items we presently tax.

Kentucky has inequities in our current Sales and Use Tax law that have resulted from exemption language that is decades old, and through litigation, has been expanded for certain entities and not others. None is more obvious than in the prescription drug and prosthetic device area. Kentucky is the only state that continues to tax certain prescription drugs.

The Governor's proposal will be essentially revenue neutral as it is applied to the sale of goods on which we are now able to collect Sales and Use Tax. In the long run, this proposal will increase revenue by enabling Kentucky to collect tax currently owed but not collected because these remote vendors do not have nexus in Kentucky. It will, over time, improve revenue collection and preserve the Sales and Use Tax as a more stable and reliable source of revenue and be more fair to the Main Street retailers who employ Kentuckians and pay other Kentucky taxes.

Streamlined Sales Tax Proposal

Amend Kentucky's current Sales and Use Tax law to comply with the National Streamlined Sales and Use Tax Agreement to position Kentucky to efficiently and effectively collect Sales and Use Tax on remote sales.

	(Million \$)		
	<u>FY 04</u>	<u>FY05</u>	<u>FY06</u>
• Exempt the remainder of Prescription Drugs	(7.1)	(15.6)	(18.1)
• Exempt the remainder of Prosthetic Devices	(2.5)	(5.5)	(6.7)
• Exempt Food including Bottled Water, but tax Dietary Supplements, all Food prepared by the seller including Bakery Items, Candy, Soft Drinks	(0.4)	(0.8)	(1.0)
• Tax Tangible Personal Property Delivered Electronically	0.8	2.2	2.3
• When computing tax on the sale of a taxable product include all delivery charges	<u>7.1</u>	<u>15.6</u>	<u>18.1</u>
	(\$2.1)	(\$4.1)	(\$5.4)

MOTOR FUELS TAX

Another issue that needs to be addressed is the Road Fund. Kentucky last increased its tax on motor fuels in 1986. Since then, 47 states have raised their Motor Fuels Tax. Only Kentucky, Georgia and Alaska have not changed their rate to reflect the changes in our economy since then. Kentucky now has the 47TH lowest Motor Fuels Tax in the nation. In due time we will have the 47TH worst roads. Our economy will suffer, our people will be inconvenienced, our neighbors will die unnecessarily.

Because of projects added in the 2000 session of the General Assembly, the Road Fund was substantially overcommitted as the administration prepared the Six-Year Road Plan for the 2002 session. Virtually no new state-funded roads were added by the Transportation Cabinet for the 2002 Six-Year Road Plan. Roads were added by the General Assembly. These commitments which can't be met are not commitments of the Administration. They are commitments of the General Assembly.

We have continued to promise our people roads with the Six-Year Road Plan, but over the next six years, state-funded road projects are \$1.1 billion over committed. Our federally funded road improvement projects are over committed by \$800 million including the 20 percent state match (\$160 million of additional state funds). In order to permit the state to meet its unfunded commitments during the past four years, the legislature has allowed the Department of Transportation to spend down its \$600 million reserve. By 2004 the reserve will be gone. The amount of highway construction, particularly the 100 percent state-funded portion, will dramatically decline. Promises made will be broken. Officeholders will be embarrassed.

There are several reasons that this tax needs to be updated. Automobile fuel efficiency has increased. Miles traveled per gallon of fuel consumed has increased. Revenue per mile traveled has decreased, but miles traveled on Kentucky's highways has increased, 58.6 percent since 1986. The cost of highway construction has increased 44 percent since 1986. The gas tax has not!

Twenty-five percent of the motor fuel tax paid to use Kentucky roads is paid by out-of-state travelers. We pay a lot more to use their roads than they pay to use ours. The fact is that many people and businesses have to use Kentucky roads. It's too expensive to bypass Kentucky.

As a part of any increase in the Motor Fuels Tax, the Motor Vehicle Usage Tax on large trucks and the trade-in value of a used car should be eliminated at a loss of \$27.5 million from used cars and \$6.2 million from large trucks.

The Governor will not be pushing for an increase in the Motor Fuels Tax at this time but he feels he should point out the problems which are on the horizon.

GAMING

The Commonwealth must consider increased gaming revenue. The Governor supports expanding gaming, but not to solve today's existing problems because the revenue can't be generated fast enough. This is the only potential source of new money to pay for needed programs such as increasing teachers' salaries, extending the school calendar, adequately funding postsecondary education and the expanding needs for human services. Casino boats on the Ohio River have stopped the growth of lottery sales in Kentucky and the impending introduction of a lottery in Tennessee in 2003 will reduce lottery income in Kentucky by about \$20 million.

The introduction of video lottery terminals at race tracks in Kentucky must be considered! This will capture about \$250 million of Kentucky's money which is currently going to the states on our border. We already have all the acknowledged evils that gambling can precipitate. We must reclaim the revenue it is taking out of Kentucky!

THE GOVERNOR'S PROPOSAL

Governor Patton proposes comprehensive tax reform intending to restore adequacy to the Commonwealth's General Fund, make our tax code more fair, improve its stability, cause it to grow more closely with the growth of our economy and the needs of a growing society and keep us competitive for economic development.

This tax reform proposal will allow Kentucky to keep its current commitments and continue to invest in the infrastructure of our schools and communities.

Table 8 summarizes the Governor's proposal to increase General Fund revenue by \$520 million and Medicaid Trust Fund revenue by \$53 million.

TABLE 8
Patton Administration 2003 Tax Proposals

	Fiscal Impact (Millions)	
	FY 04	FY 05
Comprehensive Tax Reform Measures to Increase Adequacy, Fairness, Growth, and Stability in the Tax Structure		
<i>Business Taxes</i>		
Replace the corporate income tax with a 2 Factor Business Activity Tax Based on Sales (\$0.13/\$100) and Payroll (\$0.60/\$100); and allow Credit of pass through income to individuals against individual income tax. Replace the corporate license tax with a Business License Tax at a rate of \$0.41 per \$100, extend it to business entities that offer limited liability protection.	\$ 339.6	\$ 363.4
		\$ 428.9
<i>Individual Income Taxes</i>		
Expand Low Income Credit to taxpayers at or below 100% of Poverty	\$ (31.0)	\$ (33.2)
Phase-out Pension Exclusion starting at \$39,400; permit cap to grow by CPI	\$ 75.0	\$ 77.4
Eliminate Deduction of Income Tax Paid to Foreign Countries	\$ 3.4	\$ 3.5
		\$ 3.6
<i>Property Taxes</i>		
Eliminate State Motor Vehicle and Watercraft Property Tax	\$ (83.5)	\$ (84.5)
Set and Freeze the State Property Tax Rate on Real Property at \$.135 per \$100 of Assessed Value	\$ 4.8	\$ 10.2
Exempt Intangible Personal Property from State Property Tax	\$ (33.5)	\$ (33.5)
		\$ 14.5
		\$ (33.6)
<i>Sales Taxes</i>		
Impose Sales Tax Responsibility on Dot.com Affiliates of Companies with KY Nexus	\$ 5.0	\$ 6.0
Restore Sales Tax to Unbundled Transmission and Distribution of Natural Gas	\$ 6.0	\$ 7.0
Impose Sales Tax on Certain Discretionary Services	\$ 48.8	\$ 51.0
		\$ 53.8
<i>Other Taxes</i>		
Raise the Excise Tax on Cigarettes by \$.37 per Pack and Impose a 13% Excise Tax on Other Tobacco Products	\$ 167.4	\$ 167.4
Impose Tax of \$0.001 per KWH on Merchant Power Generated in Kentucky	\$ 1.4	\$ 1.4
Consolidate and Simplify Wholesale Taxation of Alcohol Products	\$ -	\$ -
Communications Industry Tax Reform	\$ 16.3	\$ 18.3
	\$ 20.1	\$ 20.1
Total General Fund Tax Reform Measures	\$ 519.7	\$ 554.4
		\$ 628.9
<i>Provider Tax</i>		
Increase Provider Tax on Nursing Facilities from 2% to 6%	\$ 47.9	\$ 50.8
Increase Provider Tax on ICF/MR from 2% to 6%	\$ 5.0	\$ 5.3
Total Increases from Provider Taxes	\$ 52.9	\$ 56.1
		\$ 59.4
Total Tax Reform Measures	\$ 572.6	\$ 610.5
		\$ 688.3

CONCLUSION

This is a bold proposal. It will take bold and courageous leadership at all levels to enact it.

It will have to be bipartisan. Those currently running for governor will have to understand that unless this initiative is successful, the first term of the next administration will be a disaster. The second term will be questionable.

The alternative is to turn our backs on the future; to lose the momentum we've gained in education; to increase the suffering of our most vulnerable friends and neighbors; to fall behind on our infrastructure.

The future of Kentucky is at stake.

This will be a true test of the leadership of Kentucky.